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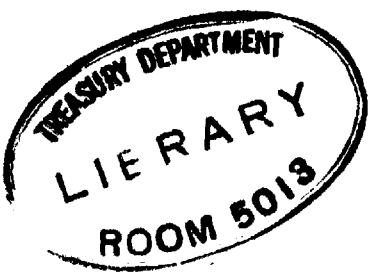
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Internal Revenue Bulletin

Cumulative Bulletin 1941-1

JANUARY-JUNE 1941

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SPECIAL ATTENTION is directed to the cautionary notice on this page that published rulings of the Bureau do not have the force and effect of Treasury Decisions and that they are applicable only to facts presented in the published case

Treasury Department : : : : : Bureau of Internal Revenue

Internal Revenue Bulletin

HF 5301 .A3 1941

Cumulative Bulletin 1941-1

JANUARY–JUNE, 1941

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The rulings reported in the Internal Revenue Bulletin are for the information of taxpayers and their counsel as showing the trend of official opinion in the administration of the Bureau of Internal Revenue; the rulings other than Treasury Decisions have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law which has not been formally approved and promulgated by the Secretary of the Treasury. Each ruling embodies the administrative application of the law and Treasury Decisions to the entire state of facts upon which a particular case rests. It is especially to be noted that the same result will not necessarily be reached in another case unless all the material facts are identical with those of the reported case. As it is not always feasible to publish a complete statement of the facts underlying each ruling, there can be no assurance that any new case is identical with the reported case. As bearing out this distinction, it may be observed that the rulings published from time to time may appear to reverse rulings previously published.

Officers of the Bureau of Internal Revenue are especially cautioned against reaching a conclusion in any case merely on the basis of similarity to a published ruling, and should base their judgment on the application of all pertinent provisions of the law and Treasury Decisions to all the facts in each case. These rulings should be used as aids in studying the law and its formal construction as made in the regulations and Treasury Decisions previously issued.

In addition to publishing all Internal Revenue Treasury Decisions, it is the policy of the Bureau of Internal Revenue to publish all rulings and decisions, including opinions of the Chief Counsel for the Bureau of Internal Revenue, which, because they announce a ruling or decision upon a novel question or upon a question in regard to which there exists no previously published ruling or decision, or for other reasons, are of such importance as to be of general interest. It is also the policy of the Bureau to publish all rulings or decisions which revoke, modify, amend, or affect in any manner whatever any published ruling or decision. In many instances opinions of the Chief Counsel for the Bureau of Internal Revenue are not of general interest because they announce no new ruling or no new construction of the revenue laws but simply apply rulings already made public to certain situations of fact which are without special significance. It is not the policy of the Bureau to publish such opinions. Therefore, the numbers assigned to the published opinions of the Chief Counsel for the Bureau of Internal Revenue are not consecutive. No unpublished ruling or decision will be cited or relied upon by any officer or employee of the Bureau of Internal Revenue as a precedent in the disposition of other cases. Unless otherwise specifically indicated, all published rulings and decisions have received the consideration and approval of the Chief Counsel for the Bureau of Internal Revenue.

UNITED STATES GOVERNMENT PRINTING OFFICE: WASHINGTON : 1941

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The Internal Revenue Bulletin service for 1941 will consist of weekly bulletins and semiannual cumulative bulletins.

The weekly bulletins will contain the rulings and decisions to be made public and all Treasury Department decisions (known as Treasury decisions) pertaining to Internal Revenue matters. The semiannual cumulative bulletins will contain all rulings and decisions (including Treasury decisions) published during the previous six months.

The complete Bulletin service may be obtained, on a subscription basis, from the Superintendent of Documents, Government Printing Office, Washington, D. C., for $3 per year; foreign, $4.25. Single copies of the weekly Bulletin, 5 cents each.

New subscribers and others desiring to obtain the 1919, 1920, and 1921 Income Tax Service may do so from the Superintendent of Documents at prices as follows: Digest of Income Tax Rulings No. 19 (containing digests of all rulings appearing in Cumulative Bulletins 1 to 5, inclusive), 50 cents per copy; Cumulative Bulletins Nos. 1 to 5, containing in full all rulings published since April, 1919, to and including December, 1921, as follows: No. 1, 30 cents; No. 2, 25 cents; No. 3, 30 cents; No. 4, 30 cents; No. 5, 25 cents.

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All inquiries in regard to these publications and subscriptions should be sent to the Superintendent of Documents, Government Printing Office, Washington, D. C.

INTRODUCTORY NOTES.

The Internal Revenue Cumulative Bulletin 1941–1, in addition to all decisions of the Treasury Department (called Treasury decisions) pertaining to Internal Revenue matters, contains opinions of the Chief Counsel, and rulings and decisions pertaining to income, estate, gift, sales, capital stock, excess profits, employment, social security, and miscellaneous taxes, as indicated on the title page of this Bulletin, published in the weekly Bulletins (1941, Nos. 1 to 26, inclusive) for the period January 1 to June 30, 1941. It also contains a cumulative list of announcements relating to decisions of the United States Board of Tax Appeals published in the Internal Revenue Bulletin Service from January 1, 1940, to June 30, 1941.

Income Tax rulings are printed in three parts. The rulings in Part I are printed as Part I, "A" (Internal Revenue Code and Revenue Acts of 1939 and 1940) and "B" (Revenue Act of 1938), the law headings corresponding with the sections of the Code and 1939 and 1938 Acts, respectively, and the regulations headings corresponding with the section headings of Regulations 103 and the article headings of Regulations 101. Rulings under the Revenue Acts of 1937 and 1936 are printed as Part II, the law headings corresponding with the section headings of those Acts and the regulations headings corresponding with the article headings of Regulations 94. Rulings under the Revenue Acts of 1935 and 1934 or prior Acts are printed as Part III, the law headings corresponding with the section headings of the Revenue Act of 1934 and the regulations headings corresponding with the article headings of Regulations 86.

Rulings under Titles VIII and IX of the Social Security Act and under Subchapters A and C, Chapter 9, of the Internal Revenue Code in force prior to January 1, 1940, are published under article headings of Regulations 91 and 90, respectively; rulings under Subchapters A and C, Chapter 9, of the Code in force on or after January 1, 1940, are published under the section headings of Regulations 106 and 107, respectively; rulings under the Carriers Taxing Act of 1937 and under Subchapter B, Chapter 9, of the Code are published under the article headings of Regulations 100; and rulings under Title III of the Revenue Act of 1936—Tax on unjust enrichment—are coded under the sections of that Act and the article headings of Regulations 95.

ABBREVIATIONS.

The following abbreviations are used throughout the Bulletin:

A, B, C, etc.—The names of individuals.
A. R. M.—Committee on Appeals and Review memorandum.
A. R. R.—Committee on Appeals and Review recommendation.
A. T.—Alcohol Tax Unit.
B. T. A.—Board of Tax Appeals.
C. B.—Cumulative Bulletin.
Ct. D.—Court decision.
C. S. T.—Capital Stock Tax Division.
C. T.—Taxes on Employment by Carriers.
D. C.—Treasury Department circular.

E. T.—Estate Tax Division.
G. C. M.—General Counsel's, Assistant General Counsel's, or Chief Counsel's memorandum.
I. R. B.—Internal Revenue Bulletin.
I. T.—Income Tax Unit.
M, N, X, Y, Z, etc.—The names of corporations, places, or businesses, according to context.
Mim.—Mimeographed letter.
MS.—Miscellaneous Division.
O. or L. O.—Solicitor's law opinion.
O. D.—Office decision.
Op. A. G.—Opinion of the Attorney General.
P. T.—Processing Tax Division.
S. T.—Sales Tax Division.
Sil.—Silver Tax Division.
S. M.—Solicitor's memorandum.
Sol. Op.—Solicitor's opinion.
S. R.—Solicitor's recommendation.
S. S. T.—Taxes on Employment by others than Carriers.
T.—Tobacco Division.
T. B. M.—Advisory Tax Board memorandum.
T. B. R.—Advisory Tax Board recommendation.
T. D.—Treasury decision.
x and y are used to represent certain numbers, and when used with the word "dollars" represent sums of money.

The practice of promulgating Treasury Decisions that embody court decisions relating to the internal revenue has been discontinued. Hereafter opinions of the courts, with appropriate headnotes for the information and guidance of taxpayers and officers and employees of the Bureau of Internal Revenue, will be published in the Internal Revenue Bulletin without formal approval and promulgation by the Secretary of the Treasury.

ANNOUNCEMENT RELATING TO BOARD OF TAX APPEALS DECISIONS.

Under the provisions of the recent Revenue Acts, relating to appeals to the Board of Tax Appeals, the Commissioner may acquiesce in the decision of the Board or he may, if the appeal was heard by the Board prior to the passage of the 1926 Act, cause to be instituted a proceeding in court for the collection of any part of a tax determined by the Commissioner to be due but disallowed by the Board, provided that such proceeding is commenced within one year after final decision of the Board. As to appeals heard by the Board after the passage of the 1926 Act, the Commissioner may, within six months after the Board's decision is rendered, file a petition for a review of the decision by a Circuit Court of Appeals or by the United States Court of Appeals for the District of Columbia; however, as to decisions rendered on and after June 7, 1932, petitions for review must be filed within three months after the decision is rendered. In order that taxpayers and the general public may be informed as to whether or not the Commissioner has acquiesced in a decision of the Board of Tax Appeals disallowing a tax determined by the Commissioner to be due, announcement will be made in the weekly Bulletin at the earliest practicable date. A notice that the Commissioner has acquiesced or has nonacquiesced in a Board decision relates, however, only to the issue or issues decided in favor of the taxpayer. Desisions so acquiesced in should be relied upon by officers and employees of the Bureau of Internal Revenue as precedents in the disposition of other cases before the Bureau.

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410	1941-9-10621	402
411	1941-10-10630	398
412	1941-11-10646	400
413	1941-15-10680	408
414	1941-17-10695	412
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415	1941-21-10723	405
416	1941-22-10726	401
417	1941-23-10734	403
418	1941-25-10753	416
Office decisions (S. T.):		
912	1941-2-10562	463
913	1941-8-10614	462
914	1941-12-10653	458
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916	1941-16-10690	465
917	1941-16-10691	466
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234	1941-5-10582	506
235	1941-9-10623	507
236	1941-14-10668	508
237	1941-15-10671	509
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239	1941-23-10739	511
240	1941-26-10761	512
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80	1941-9-10622	513
81	1941-14-10669	513
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BOARD OF TAX APPEALS.

CUMULATIVE LIST OF ANNOUNCEMENTS RELATING TO DECISIONS OF THE UNITED STATES BOARD OF TAX APPEALS PUBLISHED IN THE INTERNAL REVENUE BULLETIN SERVICE FROM JANUARY 1, 1940, TO JUNE 30, 1941, INCLUSIVE.

[Announcements relating to the acquiescence or nonacquiescence of the Commissioner in decisions of the United States Board of Tax Appeals, as published in the weekly Internal Revenue Bulletins from December 22, 1924, to December 31, 1931, inclusive, are printed in Cumulative Bulletin X-2, pages 1-106. Those printed in weekly Bulletins from January 1, 1932, to December 31, 1939, inclusive, are published in Cumulative Bulletin 1939-2, pages 1-73. The list below, therefore, contains only such announcements published in the weekly Bulletins from January 1, 1940, to June 30, 1941, inclusive.]

[a] 1941-26-10754

The Commissioner acquiesces in the following decisions of the United States Board of Tax Appeals:

Taxpayer.	Docket No.	Board of Tax Appeals.	
		Volume.	Page.
A.			
Abbott, John, executor of estate of Richard E. Traiser [1]	91958	41	228
Adair, Mrs. Cornelia, estate of	95451	43	384
Adler, E. P	97988	44	112
Affiliated Enterprises, Inc.[2]	96603	42	390
Allen, Laura, estate of [3]	89703	40	721
American Liberty Oil Co.[4]	98487 98488	43	76
American Society of Cinematographers, Inc	96411	42	675
Anderson, John, transferee of estate of Frank O. Burridge	93334	40	944
Apex Brewing Co., Inc	91977	40	1109
Appleby, John S.[5]	94080	41	18
Atlantic Land Co., The	100410	43	74
Augustus, Elizabeth G	96061	40	1200

[1] Acquiescence relates only to the Board's mathematical formula for apportionment of the dividend credit between the estate and the distributees.

[2] Acquiescence relates only to the issue, What amounts constitute reasonable allowance for services performed in 1935 and 1936 by the wives of the two principal officers of the corporation?

[3] Estate tax decision.

[4] Acquiescence relates only to the issue, Did the respondent err in including in petitioner's consolidated income for 1932 and 1933, subject to depletion, the sums of $25,727.65, $27,421.09, and $40,445.27 which petitioner's affiliate, the Wofford Production Co., paid during said years to owners of oil payment contracts on its Pinkston lease?

[5] Acquiescence relates only to the issue, Was the sum of $150 which was added by the Commissioner to John S. Appleby's income, taxable to him?

[a] Ruling No. 10754 includes all acquiescence and nonacquiescence notices published in the Internal Revenue Bulletin service from January 1, 1940, to June 30, 1941.

ACQUIESCENCES—Continued.

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B.			
Baker, Inc., Emerit E	92366 94401	40	554
Banfield, T. H.[1]	93313 98688 99999	42	769
Bank of America National Trust & Savings Association, trustee of Tonningsen Trust	99280	43	37
Bekins, Katherine, estate of [2]	87675	38	604
Bekins et al., Milo W., executors of estate of Katherine Bekins [2]	87675	38	604
Belcher, Harriet Holbrook	94879	42	633
Benaglia et ux., Arthur [3]	87638	36	838
Berks County Trust Co., alleged successor trustee of Mortgage Trust Certificate Pool	98207	42	1238
Black Motor Co., Inc	97232	41	300
Blenheim Co., Ltd	95026	42	1248
Bohn, Charles B.[4]	95953	43	953
Bondholders Committee [5]	90452 90486 90487	40	881
Briggs-Killian Co	92562	40	894
Brink et al., Virgil C., Trustees of Minnie M Fay Trusts "A," "C," and "S" [6]	98900– 98902 99522– 99524	42	765
Britt, Carl M	95566	43	254
Brookman, Murray	95871	41	557
C.			
Cain, Emma Weitmuller, executrix of estate of John E. Cain, Sr.[7]	101330	43	1133
Cain, Sr., John E., estate of [7]	101330	43	1133
Canelo, Harry F	66150 90641	41	713
Carey-Reed Co.[8]	83936	36	36
Carey Trust (Second)	93611	41	800
Carter, Shirley, estate of	93917	40	749
Castner Garage, Limited	98502	43	1
Cavett et al., K., executors of estate of W. T. Hales [9]	93208	40	1244
Center Investment Co	82350	43	46
Chamberlain et ux., Lowell H	96410	43	259
Cherokee Co	93962	41	1212
Chrysler Corporation	97305	42	795
Claiborne et al., Austin Leigh, executors of the estate of Laura Allen [7]	89703	40	721

[1] Acquiescence relates only to the issue, Is the petitioner entitled to a deduction of $6,546.96 for the year 1937, as and for a debt ascertained to be worthless and charged off during that year?

[2] Prior nonacquiescence published in Cumulative Bulletin 1939–1 (Part 1), page 40, withdrawn.

[3] Nonacquiescence published in Cumulative Bulletin 1938–1, page 35, withdrawn.

[4] Acquiescence relates only to the issue, Where a taxpayer sells stock to a trust created by him for the benefit of his daughter, does the transaction fall within section 24(a)6 of the Revenue Act of 1934 so that no deductible loss results?

[5] Acquiescence does not relate to issue respecting bases for depreciation of petitioners' assets.

[6] Acquiescence is as to result only.

[7] Estate tax decision.

[8] Prior nonacquiescence published in Cumulative Bulletin 1939–2, page 44, withdrawn.

[9] Acquiescence is only as to the issue, Do certain dividends declared and credited on the stock of the Local Building and Loan Association and made available to the petitioners in January, 1935, but applied by them against the purchase of stock in the Local Federal Savings and Loan Association into which the building and loan association was converted, represent income in 1935 subject to normal tax and surtax?

ACQUIESCENCES—Continued.

Taxpayer.	Docket No.	Board of Tax Appeals. Volume.	Page.
Cohen & Sons Co., B	97939	42	1137
Cohen Testamentary Trust, Joel C	96231	42	1074
Columbia Oil & Gas Co.[1]	90624	41	38
Combs Lumber Co	91543	41	339
Cook Drilling Co.[2]	82231	38	291
Cooledge, Norman	92289	40	1324
Cooper, Eugene B., administrator of the estate of Lewis F. Cooper	94088	40	749
Cooper, Lewis F., estate of	94088	40	749
Cooperative Insurance	95292	41	1151
Cooperative Power Plant	95291	41	1143
Crabb, Dolores	95002	41	686
Crawford Music Corporation	85389 88290	40	284
D.			
Dallas Title & Guaranty Co.[3]	90466	40	1021
Dashiell, C. R.[4]	75056	36	313
Davidson, Clinton [5]	93500 93503	43	576
Davidson, Jr. Clinton [5]	93504	43	576
Davidson, Flora S.[5]	93502	43	576
Davison-Joseph Campau Realty Co., Inc	97366	41	675
Dean, Mason L.[6]	61205 69832	35	839
Dearing, Roy E., estate of [7]	84195	36	843
Dearing, R. H., estate of, and trust estate [7]	84193 84194	36	843
Dearing, Mrs. R. H.[7]	84196	36	843
Dearing et ux., Willis R.[7]	84192 84197	36	843
Dearing, Willis R., executor of estate of Roy E. Dearing [7]	84195	36	843
Dearing, Willis R., executor of estate and trust estate of R. H. Dearing [7]	84193 84194	36	843
DeLong, David A.[8]	101264	43	1185
Deuble, George H	92055 95044	42	277
District Bond Co.[9]	88970 94486	39	739
Dolenz, Anton	93311	41	1091
Dollar, Agnes Barr	97283 98728	41	869
Dollar, J. Harold, estate of	97282 98727	41	869

[1] Acquiescence does not relate to issue pertaining to allocation of cost of equipment on the property in question.

[2] Acquiescence relates only to the issue, whether the fair market value of future oil payments, under the drilling and sale of lease contracts, should be included in gross income of petitioner for the year 1932. Previous acquiescence published in Cumulative Bulletin 1939-2, page 8, affirmed as to this issue only.

[3] Acquiescence relates only to the issue whether or not petitioner is an insurance company as that term is used in section 701(c) 2 of the Revenue Act of 1934.

[4] Nonacquiescence published in Cumulative Bulletin 1937-2, page 36, withdrawn.

[5] Acquiescence with respect to issue involving the taxability of certain commissions on life insurance contracts is as to result only.

[6] Prior nonacquiescence published in Cumulative Bulletin 1937-2, page 36, withdrawn.

[7] Prior nonacquiescence published in Cumulative Bulletin 1938-1, page 39, withdrawn.

[8] Acquiescence relates only to the issue, Is the $14,000 cash received by the petitioner on February 6, 1936, from Francis K. Lapoint a part of the consideration of the petitioner's American Broach & Machine Co. stock?

[9] Prior nonacquiescence published in Cumulative Bulletin 1939-2, page 47, withdrawn.

ACQUIESCENCES—Continued.

Taxpayer.	Docket No.	Board of Tax Appeals. Volume.	Page.
Dollar, et al., Robert H, executors of estate of J. Harold Dollar	97282, 98727	41	869
Downing et ux., Richard [1]	99171	43	1147
E.			
Einhorn, Max [2]	73893	36	954
Elmore Milling Co., Inc	96520	42	1410
Elverson Corporation [3]	93281	40	615
Equitable Life Assurance Society of the United States, The [4]	31110, 33241, 57867	33	708
Estate Planning Corporation [5]	93501	43	576
Eustis, Augustus H. [6]	71637	30	820
Evans, Mary E. [7]	95527	42	246
Ewing, Sherman [8]	93013	40	912
F.			
Farrell, Robert S	100139	44	238
Fay, Minnie M, Trust, "A," "C," and "S" [9]	98900–98902, 99522–99524	42	765
Ferree, C. B. [10]	61542	32	725
First Mortgage Bonds [11]	90452, 90486, 90487	40	881
Fish, Isaac, estate of	96527	42	260
Fitch, F. W	93340, 98131	43	773
Fleischmann, Raoul H	90305	40	671
Fleming, Mrs. Anna Maud [12]	92958, 94690	41	940
Fleming-Kimbell Corporation [12]	92959	41	940
Fleming, William [12]	92957, 94689	41	940
Floyd, Incorporated	99562	43	101
Foreman, Frank C	93915	40	749
Forrester Box Co	93748	43	657
Friend et al., Milton H., trustees of estate of Henry Friend	90672, 91415	40	767
Friend, Henry, estate of	90672, 91415	40	767
Frost Co., G. & C	100444	44	94

[1] Acquiescence relates only to the issue involving the deductibility of $95.74 as a bad debt.
[2] Prior nonacquiescence published in Cumulative Bulletin 1938–1, page 40, withdrawn.
[3] Acquiescence relates only to the issue involving the fair market value of certain pledged collateral on the date of its surrender.
[4] Prior nonacquiescence published in Cumulative Bulletin XV–1, page 31 (1936), withdrawn.
[5] Acquiescence with respect to issue involving the taxability of certain commissions on life insurance contracts is as to result only.
[6] Prior nonacquiescence published in Cumulative Bulletin XIV–2, page 30 (1935), withdrawn.
[7] Acquiescence relates to all issues except as to the deductibility of attorney's fees and abstract fees incurred incidental to the establishment of forfeiture of a lease and obtaining repossession of the leased premises.
[8] Prior nonacquiescence published in Cumulative Bulletin 1940–2, page 11, withdrawn.
[9] Acquiescence is as to result only.
[10] Nonacquiescence published in Cumulative Bulletin XIV-2, page 30 (1935), withdrawn.
[11] Acquiescence does not relate to issue respecting bases for depreciation of petitioners' assets.
[12] Acquiescence relates only to the following issues: (*a*) Did each of the communities of Kay Kimbell and wife and William Fleming and wife constructively receive oil payments of $60,848.65 and $53,401.35, respectively, for 1934 and 1935 from the Fleming-Kimbell Corporation, and (*b*) was a certain $4,000 reservation in connection with the transfer by William Fleming in 1936 of a leasehold interest in the Richter "A" lease, etc., taxable to the petitioners?

ACQUIESCENCES—Continued.

Taxpayer.	Docket No.	Board of Tax Appeals. Volume.	Page.
G.			
G. B. R. Oil Corporation	92604	40	737
Gardner, J. Willis [1] [2]	92115	41	679
Garland et ux., William J.[3]	93589	42	324
	95547	43	731
Gaylord, Inc., Robert [4]	96953	41	1119
George Bros. & Co	93248	41	287
Gillespie, Maud	98770	43	399
Gilmore, Helen, estate of, transferee of estate of Frank O. Burridge	93231	40	944
Graff, Everett D	92212	40	919
Grim, Clifford D	93919	40	749
Gruy, Joseph, independent executor of estate of Lucile Gruy	95901	42	1279
Gruy, Lucile, estate of	95901	42	1279
Gump, Alfred S., estate of [5]	90656	42	197
Gump et al., Camille R., executors of estate of Alfred S. Gump [5]	90656	42	197
H.			
Hales, George A.[6]	93210	40	1244
Hales, Mrs. Oneta [6]	93209	40	1244
Hales, Jr., W. T.[6]	93211	40	1244
Hales, W. T., estate of [6]	93208	40	1244
Harris Trust & Savings Bank et al., executors of estate of Isaac Fish	96527	42	260
Hawaiian Trust Co., Ltd., trustee of Joel Cohen Testamentary Trust	96231	42	1074
Heath, Harriet A.[7]	90599	38	1127
Heller, Edward H.[8]	94794	41	1020
	94795		
Higgins, Eugene	80052	39	1005
	85961		
Highland Farms Corporation [9]	95690	42	1314
Hirsch, L. B	95782	42	566
Honokaa Sugar Co	101358	43	151
Hooper, James P., estate of [5] [10]	85776	41	114
Hooper, Mathilde B., administratrix of estate of James P. Hooper [5] [10]	85776	41	114
Hoover, Herbert W	90974	42	289
Hopkins, William R	91753	41	1292

[1] Gift tax decision.

[2] Acquiescence relates only to the issue, if the beneficiaries of a certain trust be treated as donees, were the gifts made to them gifts of present interests or future interests?

[3] Acquiescence with respect to the decision of June 28, 1940 (42 B. T. A., 324), relates to the issue involving the taxability of interest from municipal bonds issued under the California Municipal Improvement District Act of April 20, 1915. Acquiescence with respect to the decision of February 27, 1941 (43 B. T. A., 731), relates to the issue involving the taxability of the income from a certain trust established by the petitioner for the support of his wife, the only issue presented at the second hearing and decided partly in favor of the petitioner and partly for the respondent.

[4] Acquiescence is as to result only.

[5] Estate tax decision.

[6] Acquiescence is only as to the issue, do certain dividends declared and credited on the stock of the Local Building and Loan Association and made available to the petitioners in January, 1935, but applied by them against the purchase of stock in the Local Federal Savings and Loan Association, into which the building and loan association was converted, represent income in 1935 subject to normal tax and surtax?

[7] Prior nonacquiescence published in Cumulative Bulletin 1939-1 (Part 1), page 50, withdrawn.

[8] Acquiescence relates to the issue pertaining to the trust for the petitioner's minor son Emanuel.

[9] Acquiescence relates only to the issue, Did the petitioner realize taxable gain as the result of receiving an award for compensatory damages?

[10] Acquiescence relates only to the determination of the value of the stock of William E. Hooper & Sons Co. on August 3, 1933.

ACQUIESCENCES—Continued.

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		Volume.	Page.
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Howard, Grace Adams, estate of	99851	42	449
Howard et al., George Adams, executors of estate of Grace Adams Howard	99851	42	449
Huey & Philp Hardware Co	92801	40	780
Hummel-Ross Fibre Corporation	93077	40	820
Humphreys, Murray	87899	42	857
Hyde, Mildred K., estate of	95182	42	738
Hyde, Suffolk & Berks, Marguerite[2]	81417 93257	40	1120
Hyde, Willis O., administrator of estate of Mildred K. Hyde	95182	42	738
I.			
Ide, John J	101347	43	799
Industrial Cotton Mills Co., Inc	92186	43	107
Island Securities, Limited	99082	43	1
J.			
Jaski, Sophie, trading as White House Bakery[3]	100241	43	321
Joell Co	96535	41	825
Johnston, J. Edward	93768	41	550
Jones, Carrie L., estate of[4]	91831	41	1279
Jordan Creek Placers	98057 99210	43	131
Joseph, William H	96036	43	273
K.			
Kahn, Bella[5]	73895	36	954
Kahn, Isidor[5]	73891	36	954
Kahn, Lenora[5]	73894	36	954
Kaufmann, Joel W	95082	41	408
Kaufmann, Mildred B	95083	41	408
Keller, Charlotte	93026	41	478
Kessler Oil & Gas Co	93041	41	31
Kiesau Petroleum Corporation	95760	42	69
Kimbell, Kay[6]	92956 94674	41	940
Kimbell, Mrs. Velma[6]	92955 94673	41	940
Kleberg, Alice G. K.[7]	86178	43	277
Kleberg, Alice G. K., executrix of estate of Robert J. Kleberg, Sr.[7]	86178	43	277
Kleberg, Sr., Robert J., estate of[7]	86179	43	277
Knowles, Edwin C. F	91495	40	860

[1] Acquiescence is as to result only.

[2] Acquiescence on the following issue is as to result only: In determining the net income of a trust currently distributable to the beneficiaries, should there be included the rent due under a long-term lease, the lessee having improved the premises with an office building which would become the lessor's property on forfeiture, the trust on the accrual basis having accrued the rent but also having charged it to a reserve for uncollected rents?

[3] Unjust enrichment tax decision. Acquiescence is as to result only.

[4] Estate tax decision.

[5] Prior nonacquiescence published in Cumulative Bulletin 1938-1, page 46, withdrawn.

[6] Acquiescence relates only to the following issues: (*a*) Did each of the communities of Kay Kimbell and wife and William Fleming and wife constructively receive oil payments of $60,848.65 and $53,401.35, respectively, for 1934 and 1935 from the Fleming-Kimbell Corporation, and (*b*) was a certain $4,000 reservation in connection with the transfer by William Fleming in 1936 of a lease-hold interest in the Richter "A" lease, etc., taxable to the petitioners?

[7] Acquiescence relates to all issues except that involving a bad-debt deduction of $204.50.

ACQUIESCENCES—Continued.

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		Volume.	Page.
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Laster, E. C., transferee	97716	43	159
Laster, Edward Carroll, transferee	97713	43	159
Laster Incorporated, E. C	97442	43	159
Lawrence, William Hamilton [1]	100364	44	128
Lawson et ux., Edward C	99300	42	1103
Lawson, Roberta C	99301	42	1103
Leary, Sr., H. B.[2]	76845	34	1206
Leary, Myra L.[2]	76846	34	1206
Legg, Mildred Sheppard, estate of [3]	89942	40	1073
Letts, Jr., Arthur	92857	41	1172
Levy, Ben	96037	43	273
Lipstate et ux., Phillip Harry	93255	43	18
Louisville Fire Brick Works, Inc., The	100482	43	178
Lucas, Henry M	100516	44	212
Lyon, Incorporated	93858 96546 99832	42	1094
M.			
MacConaughey, Harry E	92052	41	408
Macon, Dublin & Savannah Railroad Co	90592	40	1265
MacPherson, Mae Recor [4]	92083	39	739
Madigan et ux., E. P	101308 101309	43	549
Majestic Oil Corporation [5]	96380	42	659
Mallery et ux., Otto T.[1]	92373	42	793
Manufacturers Life Insurance Co., The	90845	43	867
Marlborough House, Inc., et al.[6]	90452 90486 90487	40	881
Marlborough Investment Co.[6]	90452 90486 90487	40	881
Marthe, Louise, transferee of estate of Frank O. Burridge	93333	40	944
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McAlpine Land & Development Co., Ltd., J. K	99599	43	520
McCormac, Gertrude A., trustee for H. B. McCormac, Jr	93920	40	749
McCormac, Jr., H. B. (trust)	93920	40	749
McKnight, Alfred, administrator of estate of Thomas Spruance	94784 94820 94821	43	221
McLean et ux., Marrs	77419 77420 81391 81392 86804 86805 94402 94403	41	565

[1] Acquiescence is as to result only.
[2] Prior nonacquiescence published in Cumulative Bulletin 1937-1, page 41, withdrawn.
[3] Estate tax decision.
[4] Prior nonacquiescence published in Cumulative Bulletin 1939-2, page 57, withdrawn.
[5] Acquiescence relates to all issues except the issue, Is the petitioner entitled to a 1935 loss deduction for the undepreciated cost of certain casing and other lease equipment which could not be removed from a certain oil well which the petitioner ceased to operate, during that year, because such operation had become unprofitable?
[6] Acquiescence does not relate to issue respecting bases for depreciation of petitioners' assets.

ACQUIESCENCES—Continued.

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		Volume.	Page.
Medical Diagnostic Association	96563	42	610
Milbank, Dunlevy [1]	93050	41	1014
Moloney Electric Co.[2]	96076	42	78
Monarch Life Insurance Co.[3]	86861 87441	38	716
Moock Electric Supply Co., The	96284	41	1209
Morris Plan Co. of St. Joseph, The	97814	42	1190
Morrison Bond Co., Ltd	93362	41	669
	95986	42	720
Mortgage Trust Certificate Pool	98207	42	1238
Morton, Arthur F	91494	41	742
Mott, Dee Furey [4]	71903	35	195
Myers, George R	94764	42	640
N.			
Nichols, J. C	89169	42	618
Nicolai, Harry T.[5]	93821 98188	42	899
Norweb, Emery May Holden [6]	92575	41	179
O.			
Ortiz, Alice duPont [7]	93159	42	173
O'Sullivan Rubber Co., Inc. (in dissolution)	97399	42	721
P.			
Pan-American Life Insurance Co.[8]	84638	38	1430
Parker, J. Brooks B	101676	44	369
Parrish, Percival	103406	44	144
Patton, T. B	93918	40	749
Peck & Peck (New York)	99288	42	651
Peck—Peck Corporation, The	99314	42	651
Perkins, Ralph [9]	96126	41	1225
Phinley Holding Co., Inc	88988	43	215
Pierce, D. W	92278	41	1261
Pinkney Packing Co	88924	42	823
Pittsburg Canners, Inc	93560	41	467
Plunkett, Theodore R	94017	41	700
Pontarelli, Michael [10]	83199	35	872
Porter et al., J. Howard, trustees, identified as Porter Properties Trustees, Ltd	95762	42	681
Porter Properties Trustees, Ltd	95762	42	681
Producers Oil Corporation	93839	43	9
Pupin, Michael I., estate of [11] [12]	92177	38	1218

[1] Acquiescence is only with respect to the taxability of the income from the wife's trust.

[2] Acquiescence relates only to the deductibility in 1936 of the amount paid to the First National Bank of St. Louis in connection with the liquidation of the Franklin American Trust Co., such acquiescence being only in the result.

[3] Prior nonacquiescence published in Cumulative Bulletin 1939-1 (Part 1), page 56, withdrawn.

[4] Nonacquiescence published in Cumulative Bulletin 1937-1, page 43, withdrawn.

[5] Acquiescence relates only to the issue, Is the petitioner entitled to a deduction of $13,225 as a bad debt for the year 1935?

[6] Gift tax decision.

[7] Acquiescence relates only to the issue, whether the petitioner is entitled to any deduction as the result of the satisfaction of the deficit existing in her husband's brokerage accounts at the end of the year 1934.

[8] Partial nonacquiescence published in Cumulative Bulletin 1939-1 (Part 1), page 59, withdrawn.

[9] Acquiescence relates only to the issue, Was the petitioner entitled to a loss on an investment of $17,250 in the Fourteenth Carnegie Co. for the year 1926?

[10] Prior nonacquiescence published in Cumulative Bulletin 1939-2, page 63, withdrawn.

[11] Estate tax decision.

[12] Prior nonacquiescence published in Cumulative Bulletin 1939-1 (Part 1), page 60, withdrawn.

ACQUIESCENCES—Continued.

Taxpayer.	Docket No.	Board of Tax Appeals. Volume.	Page.
R.			
Regals Realty Co.[1]	96360	43	194
Retsal Drilling Co	95776 97715	42	1057
Ritchie, Montgomery H. W., administrator d. b. n. of estate of Mrs. Cornelia Adair	95451	43	384
Robinson, W. C	99038	42	725
Rooke, Robert L	98112	43	275
Rosenstock, Anna, individually and as executrix of estate of Isaac M. Rosenstock[2]	91686	41	635
Rosenstock, Isaac M., estate of[2]	91686	41	635
Ross Bros. Horse & Mule Co	94476	43	1151
Ross, Mary Catherine	94475	43	1151
Ross, W. R	94474 98898	43	1151
Rossi, Andrew E.[3]	96470	41	734
Rotorite Corporation	88606	40	1303
Rowley, Edward G., transferee of estate of Frank O. Burridge	93332	40	944
S.			
Safe Deposit & Trust Co. of Baltimore, executor of estate of Mildred Sheppard Legg[2]	89942	40	1073
St. Louis Union Trust Co. et al., executors of estate of Carrie L. Jones[2]	91831	41	1279
Scanlon, Robert H.[4]	98020	42	997
Schieffelin, Lucy S., estate of	99961	44	137
Schlesinger, Rosa[5]	73892	36	954
Schley et ux., Julian Larcombe	99404	42	434
Schoellkopf, Jr., Jacob F	76377	35	855
Schultz et ux., Neils	100440 100441	44	146
Schuman Carriage Co., Ltd	90012	43	880
Seavey & Flarsheim Brokerage Co	91618	41	198
Second Carey Trust	93611	41	800
Seward City Mills	92099	44	173
Shamrock Oil & Gas Co	98588	42	1016
Sharp et ux., H. Cecil	97425 97426	42	336
Shelden Land Co.[6]	93196	42	498
Shenandoah Valley National Bank (Shirley Carter estate)	93917	40	749
Sherman, Doris Bond[4 7]	95300	41	898
Silver, Max	100186	42	461
Simon, Jose, estate of[2]	91840	40	650
Simon et al., Jose P., executors[2]	91840	40	650
Slavin, Arthur M	94768	43	1100
Smith, Charles G	93914	40	749
Smith, Madeline Welder	95003	41	686

[1] Acquiescence is as to result only.
[2] Estate tax decision.
[3] Unjust enrichment tax decision.
[4] Gift tax decision.
[5] Prior nonacquiescence published in Cumulative Bulletin 1938-1, page 55, withdrawn.
[6] Acquiescence relates only to the issue, whether certain losses suffered by petitioner as the result of foreclosures of properties owned by the petitioner are deductible in the year of foreclosure or in the year in which the equity of redemption expired.
[7] Acquiescence relates only to the year 1935.

ACQUIESCENCES—Continued.

Taxpayer.	Docket No.	Board of Tax Appeals.	
		Volume.	Page.
Smith, Varvara Pupin, administratrix of estate of Michael I. Pupin [1] [2]	92177	38	1218
Smoak, Elliott B	100036	43	907
Smyth, Jr., Francis G., transferee of estate of Frank O. Burridge	93331	40	944
Smyth, Herbert C., transferee of estate of Frank O. Burridge	93232	40	944
Smyth, Herbert C., administrator of the estate of Helen Gilmore, transferee of estate of Frank O. Burridge	93231	40	944
Sporl, Sr., Cyprian A., estate of [1]	92588	40	924
Spratt, Charles N	97917	43	503
Springford, Herbert H	97247	41	1001
Spruance, Mrs. Hortense	94785 94786	43	221
Spruance, Thomas, estate of	94784 94820 94821	43	221
Staley, Augustus E. [3]	88772	41	752
Staley, Emma L. [3]	88773	41	752
Standard Oil Co. (and affiliated subsidiaries)	86516	43	973
Stanley, William H	96558	41	1233
Stern, Allison L. S. [4]	93134	40	756
Streicker, Louis	96038	43	273
Suffolk & Berks, Marguerite Hyde [5]	81417 93257	40	1120
Sultana Oil Corporation (Delaware)	90078 90079	40	1195
Sunset-Lucille Co	93964	42	246
Sutcliffe Co., The	94235	41	1009
Swastika Oil & Gas Co	90861	40	797
T.			
Talbott, Katherine H., estate of [1]	97128	42	1081
Talbott et al., Harold E., executors of estate of Katherine H. Talbott [1]	97128	42	1081
Taylor et ux., Harden F. [6]	99262	43	563
Terhune, Wesley V. E	93894	40	749
Thatcher, Lester A., transferee of estate of Frank O. Burridge	93335	40	944
Timmerman, Louis F	96317	42	188
Title Guarantee & Trust Co. et al., executors of estate of Lucy S. Schieffelin	99961	44	137
Tonningsen Trust, John and Pauline	99280	43	37
Torney, Jeannette Wright, administratrix of estate of Millie Langley Wright [1]	99579	43	551
Traiser, Richard E., estate of [7]	91958	41	228
Trevor, Emily [3]	89820	40	1240

[1] Estate tax decision.
[2] Prior nonacquiescence published in Cumulative Bulletin 1939-1 (Part 1), page 60, withdrawn.
[3] Gift tax decision.
[4] Acquiescence relates only to the issue, Is the petitioner taxable on the income of a trust which was created for the support and maintenance of his wife and minor child?
[5] Acquiescence on the following issue is as to result only: In determining the net income of a trust currently distributable to the beneficiaries, should there be included the rent due under a long-term lease, the lessee having improved the premises with an office building which would become the lessor's property on forfeiture, the trust on the accrual basis having accrued the rent but also having charged it to a reserve for uncollected rents?
[6] Acquiescence relates only to the issue, whether gains were realized in 1936 or in 1937 from sales made on the last two days of December, 1936.
[7] Acquiescence relates only to the Board's mathematical formula for apportionment of the dividend credit between the estate and the distributees.

ACQUIESCENCES—Continued.

Taxpayer.	Docket No.	Board of Tax Appeals.	
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U.			
Union Guardian Trust Co	94687	41	1306
Union Shipbuilding Co., alleged transferee	100025	43	1143
United States Fidelity & Guaranty Co	91398	40	1010
Universal Motor Co	98503, 99752	43	1
Universal Winding Co	87354	39	962
V.			
Valley Lumber Co. of Lodi	100421	43	423
Valley Tractor & Equipment Co	95878	42	311
Valuation Service Co., The	96373	41	811
W.			
Walter, William E	97537, 99162	42	941
Washington Railway & Electric Co	92435	40	1248
Wegeforth, Lillie S	94708	42	633
Welder, Jr., James F	95005	41	686
Wheeler, Helen Evans [1]	95528	42	246
Wilcox, Elsie H.[2]	96830	43	931
Wilcox, Gaylord P.[2]	96831	43	931
Wilcox, Mabel I.[2]	96827	43	931
Wilson, John P.[3]	93140	42	1260
Wilson, Morris K	98024	42	1254
Winston Bros. Co.[4]	59270	29	905
Winthrop, Beekman [5]	79850	36	314
Wolcott, Frank E	100008	42	1151
Wolf, Edith A	92429	41	1231
Wood, Elizabeth	95004	41	686
Wood, Orrin G.[6 7]	92489	40	904
Woods Lumber Co.[8]	97474	44	88
Word, Anna	93543	41	965
Word, T. T	93542	41	965
Word Supply Co., T. T	93544	41	965
Wright, Millie Langley, estate of [9]	99579	43	551
Y.			
Young, Du Bois [10]	78345	34	648

[1] Acquiescence relates to all issues except as to the deductibility of attorney's fees and abstract fees incurred incidental to the establishment of forfeiture of a lease and obtaining repossession of the leased premises.

[2] Acquiescence relates only to the issue, Are the petitioners taxable in 1934 as beneficiaries under the will of George N. Wilcox upon income earned in 1934 by the estate during administration?

[3] Acquiescence relates only to the issue, Where taxpayer creates a trust for the lifetime of his adult daughter, is the trust income taxable to the grantor under the provisions of section 166 of the Revenue Act of 1934?

[4] Prior nonacquiescence published in Cumulative Bulletin XIII-2, page 38 (1934), withdrawn.

[5] Nonacquiescence published in Cumulative Bulletin 1937-2, page 56, withdrawn.

[6] Gift tax decision.

[7] Acquiescence relates only to the issues involving (1) the valuation of 388 shares of Brown Paper Mill stock, and (2) the question whether the relinquishment of a power to prevent future amendments to a trust instrument constitutes a complete gift.

[8] Acquiescence is as to result only with respect to the issue, Were the operations of the petitioner, the "Woods Lumber Company" of Tennessee, and the "Woods Lumber Company, Inc.," of Arkansas, the operations of a single taxable entity, so that the loss sustained by the Arkansas business could be used to reduce taxable income of the Tennessee corporation?

[9] Estate tax decision.

[10] Acquiescence relates only to this issue, Was the exchange of certain certificates of ownership in a trust for underlying portfolio stock represented there by an exchange of different assets, resulting in a capital loss? Previous nonacquiescence published in Cumulative Bulletin XV-2, page 51 (1936), withdrawn with respect to this issue only.

The Commissioner does NOT acquiesce in the following decisions of the United States Board of Tax Appeals:

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A.			
Abbott, John, executor of estate of Richard E. Traiser [1]	91958	41	228
Acme Breweries (transferee)	101296	43	721
Affiliated Enterprises, Inc.[2]	96603	42	390
Alabama Asphaltic Limestone Co	91793	41	324
Allen, H. Wadleigh, estate of	93811		
Allen, John Q	93812		
Allen, Jr., et al., Bona	93809	41	206
Allen, Jr., et al., Bona, executors	93811		
Allen et al., Victor H	93810		
Alling, Noyes E., estate of [3]	87136	41	191
Ambrose et ux., W. D	95744	42	1405
	95745		
American Liberty Oil Co.[4]	98487	43	76
	98488		
American Light & Traction Co	97234	42	1121
Appleby, Edgar S., estate of	93886	41	18
Appleby et al., Edgar T., executors of estate of Edgar S. Appleby	93886	41	18
Appleby, John S.[5]	94080	41	18
Armour, Lolita S	88151	41	777
	93150		
Atkinson, William G. (also known as Paul Cavanagh)	95500	42	1037
Avalon Paper Co., transferor	101162	43	541
B.			
Baird et ux., Warner G. and Julia Dole	97439	42	970
Banfield, T. H.[6]	93313	42	769
	98688		
	99999		
Bateman, Lady Marian	98766	43	69
Beck, Martin [7]	99439	43	147
Bedford Trust, Edward T	97260	42	748
Bell et al., Maude K., executors of estate of Ida A. White	93575	41	525
Bernheimer Co., S. E. & M. E	88978	41	249
Bingham, Mary Lily (Flagler), estate of	94985	40	823
Bishop Trust Co., Ltd., executor of estate of John A. McCandless	97943	42	1309
Blaise, E. F	98294	42	1232

[1] Nonacquiescence relates only to that part of the Board's opinion which holds, without supporting evidence, that gains on the sale of corpus of the estate constituted income available for distribution to the beneficiaries.

[2] Nonacquiescence relates only to the issue, Is the petitioner subjec to surtax as a personal holding company under sections 351 of the Revenue Acts of 1934 and 1936?

[3] Estate tax decision.

[4] Nonacquiescence relates to all issues except the issue, Did the respondent err in including in petitioner's consolidated income for 1932 and 1933, subject to depletion, the sums of $25,727.65, $27,421.09, and $40,445.27 which petitioner's affiliate, the Wofford Production Co., paid during said years to owners of oil payment contracts on its Pinkston lease?

[5] Nonacquiescence relates to all issues except the issue with respect to the $150 added by the Commissioner to the petitioner's taxable income.

[6] Nonacquiescence relates only to the issue, Should the taxable income of the petitioner for the year 1935 be increased, for the reason that a certain loss sustained during that year by the partnership, of which he is a member, resulted from the "short sale of property," within the meaning of section 117(e) of the Revenue Act of 1934?

[7] Gift tax decision.

NONACQUIESCENCES—Continued.

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Bohn, Charles B.[1]	95953	43	953
Bondholders Committee [2]	90452 90486 90487	40	881
Bonfils, F. G., estate of [3]	91501	40	1079
Bonfils Trust, F. G.[3]	93148	40	1085
Bonfils et al., Helen G., executors of estate of F. G. Bonfils [3]	91501	40	1079
Branch, Claude R	94248	40	1043
Bridgeport City Trust Co. et al., The, executors of estate of Noyes E. Alling [4]	87136	41	191
Bristol, Bennet B.[5]	96289	42	263
Brown, Antoinette K	97743	42	693
Bruckner, Arnold	97507	42	3
Buck, Ellsworth B	93330	41	99
Burnett, O. L	90248	40	604
Burnquist, Bert B	101259	44	484
C.			
California Brewing Association	101295	43	721
Carling Holding Co	86776 87378 88616	41	493
Cartex Mills, Inc	97698	42	894
Caspersen, Freda R	92765	40	758
Caughey, Carolyn G., estate of [4]	99655	44	385
Cavanagh, Paul (also known as William G. Atkinson)	95500	42	1037
Cavett et al., K., executors of estate of W. T. Hales [6]	93208	40	1244
Central Hanover Bank & Trust Co., executor of estate of W. M. L. Fiske	102055	44	227
Central Loan & Investment Co.[7]	82565	39	981
Chamberlain, Park	88067	41	10
Chaparral Oil Co	97552	43	457
Chase, Gertrude B	97902	44	39
Chase National Bank of the City of New York, The, trustee under agreements with American Depositor Corporation	93854 93855 93856 93857	41	430
Clary, P. T. (Patrick)	96496	42	1142
Cole, Rufus S	96589	42	1110
Colonial Trust Co. et al., executors	93648	41	213
Columbia Oil & Gas Co.[8]	90624	41	38
Columbia River Paper Mills	97740	43	263
	97938	43	104
Cook Drilling Co.[9]	82231	38	291

[1] Nonacquiescence relates only to the issue, Did the loss resulting from the exchanges of land contracts for Home Owners Loan Corporation bonds constitute a capital loss?
[2] Nonacquiescence relates to issue pertaining to bases for depreciation of petitioner's assets.
[3] Previous acquiescence published in Internal Revenue Bulletin 1940-15, page 1, withdrawn.
[4] Estate tax decision.
[5] Gift tax decision.
[6] Nonacquiescence is only as to the issue, Is the cash received by petitioners in 1935 from the Local Federal Savings and Loan Association, which is admitted to be income, taxable as ordinary income or as capital gain?
[7] Acquiescence published in Cumulative Bulletin 1939-2, page 6, withdrawn.
[8] Nonacquiescence relates to issue pertaining to allocation of cost of equipment on the property in question.
[9] Nonacquiescence relates only to the issue whether the petitioner is entitled to deduct the costs incurred in drilling wells. Prior acquiescence published in Cumulative Bulletin 1939-2, page 8, withdrawn as to this issue only.

NONACQUIESCENCES—Continued.

Taxpayer.	Docket No.	Board of Tax Appeals.	
		Volume.	Page.
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Corpus Christi Terminal Co	88103	38	944
Covington et ux., George W	98283	42	601
Credit Alliance Corporation	100561	42	1020
Crichton, Kate J	97025	42	490
Crown Zellerbach Corporation, transferee	101161 101163 101166 101168 101170	43	541
Cushman, Louise C., transferee of estate of Mary W. Cushman [1]	92881	40	947
Cushman, Mary W., estate of [1]	92882 92883	40	947
D.			
Dallas Title & Guaranty Co.[2]	90466	40	1021
Deering, Frank C., estate of	95996	40	983
Deering et al., Joseph Godfrey, executors of the estate of Frank C. Deering	95996	40	983
Delaware Terminal Corporation	86105	40	1179
DeLong, David A.[3]	101264	43	1185
Denholm & McKay Co	89606	39	767
Denver National Bank et al., trustees u/w F. G. Bonfils [4]	93148	40	1085
Downing et ux., Richard [5]	99171	43	1147
Dunning, Henry A. B	92629	41	1101
Durkheimer, S. F	95209	41	585
E.			
Edwards Drilling Co.[6]	75931	35	341
Elias, Edna B	90827	41	1109
Elmhirst, Dorothy Whitney	85040 85880 95298	41	348
Elston Co., Ltd	96604	42	208
Elverson Corporation [7]	93281	40	615
Erb et al., Arthur L., executors of estate of Giles W. Mead [8]	97566	41	424
Estates Administration, Inc., administrator of estate of Zachary Smith Reynolds [1]	86395	42	145
Evans, Mary Boyd	97432	42	851
Evans, Mary E.[9]	95527	42	246

[1] Estate tax decision.

[2] Nonacquiescence relates only to the issue involving the taxability of an amount of $40,000 transferred from "Premium reserve account" to "Undivided profits account" pursuant to resolution of the board of directors on July 5, 1934.

[3] Nonacquiescence relates only to the issue involving the amount of gain recognizable in 1936 upon the receipt of cash and stock in the Sundstrand Machine Tool Co. for stock in the American Broach & Machine Co.

[4] Previous acquiescence published in Internal Revenue Bulletin 1940-15, page 1, withdrawn.

[5] Nonacquiescence relates only to the issue whether Mrs. Irma Downing is liable for any part of the deficiency.

[6] Nonacquiescence relates only to the issue whether the petitioner is entitled to deduct the costs incurred in drilling oil wells. Prior acquiescence published in Cumulative Bulletin 1939-1, page 11, withdrawn as to this issue only.

[7] Nonacquiescence relates only to the issue, Was the income resulting from the receipt of surrendered collateral in extinguishment of a debt personal holding company income?

[8] Gift tax decision.

[9] Nonacquiescence relates only to the deductibility of attorney's fees and abstract fees incurred incidental to the establishment of forfeiture of a lease and obtaining repossession of the leased premises.

NONACQUIESCENCES—Continued.

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F. H. E. Oil Co	92960	41	130
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Farmers & Ginners Cotton Oil Co	93436	41	1083
Farmers Union Cooperative Exchange	100552	42	1200
First Mortgage Bonds [1]	90452, 90486, 90487	40	881
First Trust & Deposit Co. et al., guardians	90749, 90750, 90751	41	107
Fiske, W. M. L., estate of	102055	44	227
Fleming, Mrs. Anna Maud [2]	92958, 94690	41	940
Fleming-Kimbell Corporation [2]	92959	41	940
Fleming, William [2]	92957, 94689	41	940
Fowler et ux., John O	91162	40	1293
Frazier, Frederic H	91412	41	146
G.			
Gadian Co., Ltd	96605	42	208
Gardner, J. Willis [3 4]	92115	41	679
Giannini et ux., A. P	87127, 87128	42	546
Gloss [Glos], Lucy M. [3]	90391	41	1239
Goodman, Edwin	87799	41	472
Greene, A. Crawford, guardian of estate of Alice H. Lester [3]	93404, 96315	41	515
Greve, William M	97522	42	142
Grote et ux., Ben	94442, 94443	41	247
H.			
Hales, George A. [5]	93210	40	1244
Hales, Mrs. Oneta [5]	93209		
Hales, Jr., W. T. [5]	93211		
Hales, W. T., estate of [5]	93208		
Halsey, Lilian Johnson, executrix of estate of Richard Hemmons Halsey [6]	96404	42	607
Halsey, Richard Hemmons, estate of [6]	96404	42	607
Hartford-Connecticut Trust Co., The, executor of estate of Mary W. Cushman [6]	92882	40	947
Heller, Edward H. [7]	94794, 94795	41	1020
Hercules Motor Corporation	92225	40	908
Highland, Cecil B., executor of estate of Virgil L. Highland	98726	43	598

[1] Nonacquiescence relates to issue pertaining to bases for depreciation of petitioner's assets.
[2] Nonacquiescence is only with respect to the holding that the petitioners would realize no taxable income from the exchange of their oil, equipment, and personal property interest for contingent oil payments until they recovered the cost of the exchanged property from the oil payments received.
[3] Gift tax decision.
[4] Nonacquiescence relates only to the issue, In the case of a gift of securities in trust, should the trust be treated as the donee, resulting in only one exclusion, or should the beneficiaries be treated as donees, resulting in one exclusion for each beneficiary?
[5] Nonacquiescence is only as to the issue, Is the cash received by petitioners in 1935 from the Local Federal Savings and Loan Association, which is admitted to be income, taxable as ordinary income or as capital gain?
[6] Estate tax decision.
[7] Nonacquiescence relates to the issue whether petitioner was taxable on the income derived from certain securities placed in certain agency accounts with a bank in petitioner's name as trustee for his minor children.

NONACQUIESCENCES—Continued.

Taxpayer.	Docket No.	Board of Tax Appeals. Volume.	Page.
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Highland, Virgil L., estate of	98726	43	598
Hoffman, Katherine M	96741	40	459
Hoffman, W. W	96742		
Hoffman et ux., W. W	92414		
Hooper, James P., estate of [2 3]	85776	41	114
Hooper, Mathilde B., administratix of estate of James P. Hooper [2 3]	85776	41	114
Hopkinson, Bessie B	97014	42	580
Hughes Tool Co	90002	40	962
J.			
Jarvis, Jr., Amilius, guardian of William D. P. Jarvis	99227	43	439
Jarvis, William D. P., an infant	99227	43	439
Jewel Mining Co	99266	43	1123
Johnson County Realty Co	96314	44	121
Johnson, Earle F	97388	43	960
Johnson et al., Thomas M., trustees	86776	41	493
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Johnston, Katherine S., estate of [2]	86395	42	145
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K.			
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Kellogg, Cornelia V. W., executrix of estate of Frederick R. Kellogg [2]	89143	40	915
Kellogg, F. W	95135	42	64
Kellogg, Frederick R., estate of [2]	89143	40	915
Kenan et al., William R., Jr., trustees u/w Mary Lily (Flagler) Bingham	94985	40	823
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	94674		
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Kleberg, Alice G. K.[5]	86178	43	277
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Lamont, Elizabeth K	97407	43	61
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	96315		

[1] Nonacquiescence relates to all issues except the issue, Did the petitioner realize taxable gain as the result of receiving an award for compensatory damages?

[2] Estate tax decision.

[3] Nonacquiescence relates only to the issue, Was the sum of $132,345.73, representing the net proceeds of certain life insurance policies assigned by the decedent to a certain trust, properly includible in the gross estate; and, if so, may the sum of $40,000 be excluded under the provisions of section 302(g) of the Revenue Act of 1926?

[4] Nonacquiescence is only with respect to the holding that the petitioners would realize no taxable income from the exchange of their oil, equipment, and personal property interest for contingent oil payments until they recovered the cost of the exchanged property from the oil payments received.

[5] Nonacquiescence relates only to the issue involving a bad-debt deduction of $204.50.

[6] Gift tax decision.

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Neustadt et al., Agnes, trustees u/w Sigmund Neustadt	99935	43	848
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Newport Industries, Inc	92331	40	977

[1] Nonacquiescence relates only to the issue, Is the petitioner entitled to a 1935 loss deduction for the undepreciated cost of certain casing and other lease equipment which could not be removed from a certain oil well which the petitioner ceased to operate during that year, because such operation had become unprofitable?

[2] Nonacquiescence relates to issue pertaining to bases for depreciation of petitioner's assets.

[3] Gift tax decision.

[4] Estate tax decision.

[5] Nonacquiescence is only with respect to the taxability of the income from the so-called short term trusts.

[6] Nonacquiescence relates only to the issue, Is the petitioner entitled to a credit under section 26(c)2 of the Revenue Act of 1936 in the amount of $13,810, representing 2 per cent of the largest amount of bonds at any one time outstanding during 1936?

[7] Acquiescence as to one issue published in Cumulative Bulletin 1939-2, page 26, withdrawn.

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Safe Deposit & Trust Co. of Baltimore, trustee under wills of R. J. Reynolds and Katherine S. Johnston, and deed of Katherine S. Johnston [4]	86394	42	145
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Schwabacher, Sophie D	101268	43	1177

[1] Nonacquiescence relates only to the issue, Is the income of a trust paid to the petitioner's divorced and remarried wife taxable to him, as the grantor?

[2] Nonacquiescence relates to all issues except the issue, whether the petitioner is entitled to any deduction as the result of the satisfaction of the deficit existing in her husband's brokerage accounts at the end of the year 1934.

[3] Nonacquiescence relates only to the issue, Did the petitioner sustain a loss in the amount of $13,963.50 on the sale of second preferred and common stock of the Hill Clutch Machine & Foundry Co.?

[4] Estate tax decision.

[5] Gift tax decision.

[6] See G. C. M. 22404 (page 204, Cumulative Bulletin 1940-2).

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Taylor et ux., Harden F.[6]	99262	43	563
Thompson, Mary H., executrix of estate of William G. Thompson [7]	96358	41	901
Thompson, William G., estate of [7]	96358	41	901
Title Guarantee & Trust Co., trustee under deed of trust from Edward T. Bedford, dated December 1, 1928	97260	42	748
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Towne, William Stark	99197	42	1046
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Trico Securities Corporation	85176	41	306
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Union Trust Co. of the District of Columbia, The executor of estate of Carolyn G. Caughey [7]	99655	44	385
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Walker, William T.[2]	92600	40	762
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Watson, Archibald R	87873 88048 89650	42	52
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[1] Nonacquiescence relates only to the issue whether petitioner is entitled to a deduction for an asserted loss on an alleged sale of certain land to another corporation.
[2] Gift tax decision.
[3] Nonacquiescence relates only to the year 1936.
[4] Nonacquiescence relates only to the issue, Where termination of a trust could occur only at the election of the grantor with concurrence of attorneys who represented two persons interested in the trust, is the interest of the attorneys a substantial adverse interest?
[5] Prior acquiescence published in Cumulative Bulletin 1939-1 (Part 1), page 34, withdrawn.
[6] Nonacquiescence relates only to the issue involving the exchange in 1936 of 600 shares of Pressed Steel Car Co. (N. J.) for stock and rights in Pressed Steel Car Co. (Pa.)
[7] Estate tax decision.
[8] Nonacquiescence relates only to that part of the Board's opinion which holds, without supporting evidence, that gains on the sale of corpus of the estate constituted income available for distribution to the beneficiaries.

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Wilcox, Mabel I.[2]	96827	43	931
Wilson, John P.[3]	93140	42	1260
Wood, Orrin G.[4 5]	92489	40	904

[1] Nonacquiescence relates only to the deductibility of attorney's fees and abstract fees incurred incidental to the establishment of forfeiture of a lease and obtaining repossession of the leased premises.

[2] Nonacquiescence relates only to the issue. Are the petitioners taxable in 1935 as beneficiaries under the will of Emma Lyman Wilcox upon income earned in 1935 by the estate during administration?

[3] Nonacquiescence relates to the issues, Whether the income of a 2-year trust created for the benefit of the taxpayer's adult son is taxable to the grantor under section 166 of the Revenue Act of 1934, and whether the capital gains of a lifetime trust created for the benefit of an adult daughter are taxable to the grantor under section 167 of the Revenue Act of 1934?

[4] Gift tax decision.

[5] Nonacquiescence relates only to the issue, Is the value of life insurance policies to be determined by the cost to purchase similar contracts as determined by the Commissioner, or is the value limited to the cash surrender value as contended by petitioner?

CONSOLIDATED EXCESS PROFITS TAX REGULATIONS.

(REGULATIONS 110.)

1941–12–10656

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 33.

Regulations relating to consolidated returns of affiliated corporations prescribed under section 730(b) of the Excess Profits Tax Act of 1940 (Subchapter E of Chapter 2 of the Internal Revenue Code as added by the Second Revenue Act of 1940).*

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SUBCHAPTER E—EXCESS PROFITS TAX.

SEC. 730. CONSOLIDATED RETURNS.

(a) **Privilege to File Consolidated Returns.**—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all the corporations which have been members of the affiliated group at any time during the taxable year for which the return is made consent to all the regulations under subsection (b) prescribed prior to the last day prescribed by law for the filing of such return; and the making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

(b) **Regulations.**—The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the excess profits tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

(c) **Computation and Payment of Tax.**—In any case in which a consolidated return is made the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under subsection (b) prescribed prior to the last day prescribed by law for the filing of such return. Only one specific exemption of $5,000 provided in section 710(b)(1) shall be allowed for the entire affiliated group of corporations.

(d) **Definition of "Affiliated Group".**—As used in this section, an "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) At least 95 per centum of each class of the stock of each of the includible corporations (except the common parent corporation)

is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly at least 95 per centum of each class of the stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

(e) **Definition of "Includible Corporation".**—As used in this section, the term "includible corporation" means any corporation except—

(1) Corporations exempt from the tax imposed by this subchapter.

(2) Foreign corporations.

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

(4) Corporations entitled to the benefits of section 251, by reason of receiving a large percentage of their income from possessions of the United States.

(5) Personal service corporations.

(6) Insurance companies subject to taxation under section 201, 204, or 207.

(f) **Includible Insurance Companies.**—Despite the provisions of paragraph (6) of subsection (e), two or more domestic insurance companies each of which is subject to taxation under the same section of Chapter 1 shall be considered as includible corporations for the purpose of the application of subsection (d) to such insurance companies alone.

(g) **Subsidiary Formed to Comply With Foreign Law.**—In the case of a domestic corporation owning or controlling, directly or indirectly, 100 per centum of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for the purpose of this subchapter as a domestic corporation.

(h) **Suspension of Running of Statute of Limitations.**—If a notice under section 272(a) in respect of a deficiency for any taxable year is mailed to a corporation, the suspension of the running of the statute of limitations, provided in section 277, shall apply in the case of corporations with which such corporation made a consolidated return for such taxable year.

SEC. 7. CONSOLIDATED RETURNS OF INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL. (EXCESS PROFITS TAX AMENDMENTS OF 1941.)

Section 730(e)(6) of the Internal Revenue Code is amended to read as follows:

"(6) Insurance companies subject to taxation under section 201 or 207."

SECTION 33.0 **Introductory.**

These regulations, authorized by section 730(b)[1] of the Internal Revenue Code as added by the Second Revenue Act of 1940, are pre-

[1] The report of the Committee on Finance (Rept. No. 2114, 76th Cong., 3d sess., p. 17) accompanying the Second Revenue Act of 1940 contains the following statement:

"The regulations which the Commissioner is authorized to prescribe are such regulations as he may deem necessary in order that the tax liability of any affiliated group of cor-

scribed as a supplement to the excess profits tax regulations applicable generally under the Code. They are applicable to all taxable years beginning after December 31, 1939.

The several sections of these regulations have been given numbers corresponding respectively to the section numbers of prior income tax consolidated returns regulations but, in accordance with the rules of the Federal Register, preceded by the Code number 33.

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porations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the excess-profits tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability in addition to the matters which, in the light of current and previous consolidated returns regulations, are expected to be covered in detail in the regulations to be issued by the Commissioner, are the extent to which and the manner in which the following items, among others, will be computed and given effect in determining the excess-profits-tax liability of an affiliated group: (*a*) Equity invested capital, borrowed capital, and invested capital, (*b*) admissible and inadmissible assets, and excluded capital, (*c*) net capital additions and reductions, (*d*) consolidated net operating losses, net operating losses incurred by members of the group in taxable years prior to that for which the consolidated return is filed, and the net operating loss deduction of members of the group in taxable years following that for which the consolidated return was filed, and (*e*) excess-profits net income and adjusted excess-profits net income."

The report of the Committee on Ways and Means (Rept. No. 1860, 75th Cong., 3d sess., p. 44) accompanying the revenue bill of 1938 (the pertinent provisions of which were reenacted without change in substance in the Internal Revenue Code) contains the following statement in regard to income tax consolidated returns regulations:

"Among the matters to be detailed in regulations which the Commissioner is expected to prescribe under the provisions of subsection (b) of this section are (*a*) the treatment of inter-company dividend distributions, (*b*) of definitions of the 'net income,' the 'adjusted net income,' and the 'special class net income' of the affiliated group, and (*c*) the computation of the 'net operating loss,' the 'basic surtax credit,' the 'dividend carry-over,' the 'dividends paid credit,' and the 'capital gains and losses,' insofar as these several factors may pertain to the case of an affiliated group."

With respect to the corresponding income tax section of the Revenue Act of 1928, the report of the Committee on Finance (S. Rept. No. 960, 70th Cong., 1st sess., p. 15) accompanying the revenue bill of 1928 contains the following statement (a similar statement being contained also in the statement of the managers on the part of the House, accompanying the conference report upon the bill, see H. Rept. No. 1882, 70th Cong., 1st sess., pp. 16–17):

"Among the regulations which it is expected that the Commissioner will prescribe are: (1) The extent to which gain or loss shall be recognized upon the sale by a member of the affiliated group of stock issued by any other member of the affiliated group or upon the dissolution (whether partial or complete) of a member of the group; (2) the basis of property (including property included in an inventory), acquired, during the period of affiliation, by a member of the affiliated group, including the basis of such property after such period of affiliation: (3) the extent to which and the manner in which net losses sustained by a corporation before it became a member of the group shall be deducted in the consolidated return; and the extent to which and the manner in which net losses sustained during the period for which the consolidated return is filed shall be deducted in any taxable year after the affiliation is terminated in whole or in part; (4) the extent to which and the manner in which gain or loss is to be recognized, upon the withdrawal of one or more corporations from the group, by reason of transactions occurring during the period of affiliation; and (5) that the corporation filing the consolidated return must designate one of their members as the agent for the group, in order that all notices may be mailed to the agent, deficiencies collected, refunds made, interest computed, and proceedings before the Board of Tax Appeals conducted as though the agent were the taxpayer."

SEC. 33.1 **Privilege of Making Consolidated Returns.**

(*a*) Section 730 gives to the corporations of an affiliated group the privilege of making a consolidated excess profits tax return for the taxable year in lieu of separate returns. This privilege, however, is given upon the condition that *all* corporations which have been members of the affiliated group at any time during the taxable year for which the return is made consent to these regulations, and any amendments thereof duly prescribed prior to the last day prescribed by law for the filing of the return; and the making of the consolidated return is considered as such consent. The last day prescribed by law for the filing of the return includes the last day of the period of any extension of time granted by the Commissioner.

(*b*) The tax liability of the members of the affiliated group for such year will be determined in accordance with such regulations and without regard to any changes made subsequent to the last day prescribed by law for the filing of such return of the rules therein prescribed.*

SEC. 33.2 **Definitions.**

(*a*) *Code.*

The term "Code" means the Internal Revenue Code, as amended, and the sections of statutory law referred to in these regulations, unless otherwise stated, are sections of that Code.

(*b*) *Affiliated Group.*

The term "affiliated group" includes the common parent corporation and every other corporation for the period during which such corporation is a member of the affiliated group within the meaning of section 730. It does not include (1) any corporation which under section 730 cannot be included in a consolidated return, (2) an insurance company taxable under section 201 or 207 in the case of a consolidated return for corporations taxable under section 13, 14, or 204, (3) a corporation taxable under section 13, 14, or 204 in the case of a consolidated return for insurance companies taxable under section 201 or 207, (4) an insurance company taxable under section 201 in the case of a consolidated return for insurance companies taxable under section 207, or (5) an insurance company taxable under section 207 in the case of a consolidated return for insurance companies taxable under section 201.

In the case of a domestic corporation owning or controlling, directly or indirectly, 100 per cent of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of Canada or of Mexico and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for excess profits tax purposes as a domestic cor-

poration. The option to treat such foreign corporation as a domestic corporation so that it may be included in a consolidated return must be exercised at the time of making the consolidated return, and cannot be exercised at any time thereafter. If the election is exercised to treat such foreign corporation as a domestic corporation, it must be included in the consolidated return of the affiliated group of which it is a member for each year thereafter for which such group makes or is required to make a consolidated return.

An affiliated group of corporations, within the meaning of section 730, is formed at the time that the common parent corporation becomes the owner directly of at least 95 percent of each class of the stock (as defined by section 730(d)) of another corporation. A corporation becomes a member of an affiliated group at the time that one or more members of the group become the owners directly of at least 95 percent of each class of its stock. A corporation ceases to be a member of an affiliated group when the members of the group cease to own directly at least 95 percent of each class of its stock.

(*c*) *Consolidated Return Period.*

The term "consolidated return period" means the first taxable year beginning after December 31, 1939, or any subsequent taxable year, for which a consolidated return is made or is required, including the period during which a subsidiary corporation is engaged in distributing its assets in liquidation.

(*d*) *Subsidiary.*

The term "subsidiary" means a corporation (other than the common parent corporation) which is a member of the affiliated group during any part of the consolidated return period.

(*e*) *Tax.*

The term "tax" means the excess profits tax imposed by the Excess Profits Tax Act of 1940, and includes any interest, penalty, additional amount, or addition to the tax, payable in respect thereof.

(*f*) *Consolidated Return.*

The term "consolidated return" means a consolidated excess profits tax return.

(*g*) *Terms Defined in Internal Revenue Code, as amended.*

Terms which are defined in the Code, as amended, shall, when used in these regulations, have the meaning assigned to them by the Code, as amended, unless specifically otherwise defined. (See, for example, "adjusted net income," section 13; "normal-tax net income," section 13 as amended by section 201 of the Revenue Act of 1939; "special class net income," section 14 prior to its amendment by section 201 of the Revenue Act of 1939; "net income," section 21; "gross income," section 22; "taxable year" and "fiscal year," section 48; "deficiency," section 271; and the terms defined in section 3797, particularly the terms "person," "stock," and "corporation.")*

SEC. 33.3 **Applicability of Other Provisions of Law.**

Any matter in the determination of which the provisions of these regulations are not applicable shall be determined in accordance with the provisions of the Code or other law applicable thereto.*

ADMINISTRATIVE PROVISIONS.

SEC. 33.10 **Exercise of Privilege.**

(*a*) *When Privilege Must be Exercised.*

The privilege of making a consolidated return under these regulations for any taxable year of an affiliated group must be exercised at the time of making the return of the common parent corporation for such year. Under no circumstances can such privilege be exercised at any time thereafter. The filing of separate returns for a taxable year does not constitute an election binding upon the corporations in subsequent years. If the privilege is exercised at the time of making the return, separate returns cannot thereafter be made for such year. (See, however, section 33.18, relating to the improper inclusion in the consolidated return of the income of a corporation.)

(*b*) *Effect of Tentative Returns.*

In no case will the privilege under paragraph (*a*) be considered as exercised at the time of making a so-called "tentative return" (made, for example, in order to obtain an extension of time for making the return required by law). However, if any such tentative return is made upon the basis of a consolidated return or a separate return, the return required by law must be made upon the same basis, unless upon the making of the return required by law (either a separate return or a consolidated return, as the case may be) the payments theretofore made and to be made are adjusted in a manner satisfactory to the Commissioner.*

SEC. 33.11 **Consolidated Returns for Subsequent Years.**

(*a*) *Consolidated Returns Required for Subsequent Years.*

If a consolidated return is made under these regulations for any taxable year, a consolidated return must be made for each subsequent taxable year during which the affiliated group remains in existence unless (1) a corporation (other than a corporation created or organized, directly or indirectly, by a member of the group) has become a member of the group during such subsequent taxable year, or (2) one or more provisions of these regulations, which have been consented to, have been amended in a manner adversely affecting the interests of the group or any of its members, or (3) the Commissioner, prior to the time of making the return, upon application made by the common parent corporation and for good cause shown, grants permission to change.

(*b*) *Effect of Separate Returns When Consolidated Return Required.*

If the making of a consolidated return is required for any taxable year, the tax liability of the members of the affiliated group shall be computed in the same manner as if a consolidated return had been made, even though separate returns are made; amounts assessed upon the basis of separate returns shall be considered as having been assessed upon the basis of a consolidated return; and amounts paid upon the basis of separate returns shall be considered as having been paid by the common parent corporation. In such cases the making of separate returns shall not be considered as the making of a return for the purpose of computing any period of limitation or any deficiency. If a consolidated return for such taxable year is thereafter made, such return shall for the purpose of computing periods of limitation and any deficiency be considered as the return for such year.

(*c*) *When Affiliated Group Remains in Existence.*

For the purposes of these regulations, an affiliated group shall be considered as remaining in existence if the common parent corporation remains as a common parent and at least one subsidiary remains affiliated with it, whether or not such subsidiary was a member of the group at the time the group was formed and whether or not one or more corporations have become subsidiaries or have ceased to be subsidiaries at any time after the group was formed.

(*d*) *When Affiliated Group Terminates.*

For the purposes of these regulations, an affiliated group shall be considered as terminated if the common parent corporation ceases to be the common parent or if there is no subsidiary affiliated with it.*

SEC. 33.12 **Making Consolidated Return and Filing Other Forms.**

(*a*) *Consolidated Return Made by Common Parent Corporation.*

A consolidated return shall be made on Form 1121 by the common parent corporation for the affiliated group. Such return shall be filed at the time and in the office of the collector of the district prescribed for the filing of a separate return by such corporation.

(*b*) *Authorizations and Consents Filed by Subsidiaries.*

Each subsidiary must prepare duplicate originals of Form 1122E, consenting to these regulations and authorizing the common parent corporation to make a consolidated return on its behalf for the taxable year and authorizing the common parent (or, in the event of its failure, the Commissioner or the collector) to make a consolidated return on its behalf (as long as it remains a member of the affiliated group), for each year thereafter for which, under section 33.11(*a*), the making of a consolidated return is required. One of such forms as prepared by each subsidiary shall be attached to the consolidated return, as a part thereof; and the other shall be filed, at or before the time the consolidated return is filed, in the office of the collector for

the district prescribed for the filing of a separate return by such subsidiary. No such consent can be withdrawn or revoked at any time after the consolidated return is filed.

(c) *Affiliations Schedule Filed by Common Parent Corporation.*

The common parent corporation shall prepare Form 851E (Affiliations Schedule), which shall be attached to the consolidated return, as a part thereof.

(d) *Persons Qualified to Swear to Returns and Forms.*

Each return or form required to be made or prepared by a corporation must be sworn to by the persons authorized under section 52 to swear to returns of separate corporations. In cases where receivers or trustees in bankruptcy are operating the property or business of corporations, each return or form required to be made or prepared by such corporation must be executed by the receiver or trustee, as the case may be, pursuant to an order or instructions of the court, and be accompanied by a copy of such order or instructions.

(e) *Signatures in Case Subsidiary Has Left Affiliated Group.*

Since Form 1122E is required even though, during the taxable year of the common parent corporation, the subsidiary (because of a dissolution or sale of stock, or otherwise) has ceased to be a member of the affiliated group, it may be advisable for the common parent to obtain the proper signature to the form prior to the time the subsidiary ceases to be a member of the group.*

SEC. 33.13 **Change in Affiliated Group During Taxable Year.**[2]

(a) *General Rule.*

Except as hereinafter provided, a consolidated return must include the income of the common parent corporation and of each subsidiary for the entire taxable year of the affiliated group.

(b) *Formation of Affiliated Group After Beginning of Year.*

If an affiliated group is formed after the beginning of the taxable year of the corporation which becomes the common parent corporation, the consolidated return must include the income of the common parent for its entire taxable year (excluding any portion of such year during which its income is included in the consolidated return of another affiliated group) and the income of each subsidiary from the time it became a member of the affiliated group.

(c) *Complete Termination of Affiliated Group Prior to Close of Taxable Year.*

If an affiliated group is terminated prior to the close of the taxable year of the group, the consolidated return must include the income of the common parent corporation for its entire taxable year (excluding any portion of such year during which its income is included in

[2] This section has no bearing upon the question whether a consolidated return may or must be made, but relates only to the effect of changes in the affiliated group during the taxable year.

the consolidated return of another affiliated group) and of each subsidiary for the period prior to the termination. (See paragraphs (*c*) and (*d*) of section 33.11, in determining whether the group has terminated.)

(*d*) *Addition to Affiliated Group of a Subsidiary During Year.*

If a corporation becomes a member of the affiliated group during the taxable year of the group, the consolidated return must include its income from the time when it became a member of the group.

(*e*) *Elimination from Affiliated Group of a Subsidiary During Year.*

If a subsidiary ceases to be a member of the affiliated group during the taxable year of the group, the consolidated return must include its income for the period during which it was a member of the group.

(*f*) *Period of 30 Days or Less May be Disregarded.*

A subsidiary may at its option be considered as having been a member of the affiliated group during the entire taxable year of the group (or during the entire period of the existence of the subsidiary, whichever is shorter) if the period during which it was not a member of such group does not exceed 30 days. If a corporation has been a member of the affiliated group for a period of less than 31 days during the taxable year of the group, it may at its option be considered as not having been a member of the group during the taxable year. An option under this paragraph must be exercised at or before the time when the consolidated return is made.

(*g*) *Separate Returns for Periods Not Included in Consolidated Return.*

If a corporation, during its taxable year (determined without regard to the affiliation), becomes a member of an affiliated group, its income for the portion of such taxable year not included in the consolidated return of such group must be included in a separate return (or, if a member of another affiliated group which makes a consolidated return for such period, then in such consolidated return). If a corporation ceases to be a member of the affiliated group during the taxable year of the group, its income for the period after the time when it ceased to be a member of the group must be included in a separate return (or, if it becomes a member of another affiliated group which makes a consolidated return for such period, then in such consolidated return).

(*h*) *Time for Making Separate Returns for Periods Not Included in Consolidated Return.*

If a corporation, during its taxable year (determined without regard to the affiliation), becomes a member of an affiliated group, the separate return required for the portion of such taxable year during which it was not a member of the group must be made on or before the 15th day of the third month following the close of its taxable year

(determined without regard to affiliation). For example, Corporation P, reporting its income on a calendar year basis, acquires on January 1, 1941, all the stock of Corporation S, which reports its income on a fiscal year basis ending March 31. P and S elect to make a consolidated return for the calendar year 1941. The separate return of S for the taxable period April 1, 1940, to December 31, 1940, should be made on or before June 15, 1941.*

SEC. 33.14 **Accounting Period of an Affiliated Group.**

The taxable year of an affiliated group which makes a consolidated excess profits tax return shall be the same as the taxable year of the common parent corporation; and, upon having elected to file consolidated returns, each subsidiary corporation shall, not later than the close of the first consolidated excess profits tax taxable year ending thereafter, adopt an annual accounting period, fiscal year or calendar year as the case may be, in conformity with that of the common parent.

If a change of accounting period is made by a subsidiary in order to conform with that of the common parent and if the requirements of section 19.46–1, Regulations 103, relating to notice of change, can not otherwise be complied with, such notice shall be furnished at or before the time of filing the consolidated return.

With respect to computations for years involved in the change to the consolidated basis, see section 33.32.*

SEC. 33.15 **Liability for Tax.**

(*a*) *Several Liability of Members of Affiliated Group.*

Except as provided in paragraphs (*b*) and (*c*), the common parent corporation and each subsidiary, a member of the affiliated group during any part of a consolidated return period, shall be severally liable for the tax (including any deficiency in respect thereof) computed upon the consolidated adjusted excess profits net income of the group.

(*b*) *Liability of a Corporation in Bankruptcy or Receivership.*

If, at the time of filing a consolidated return, one or more, but not all, of the members of the affiliated group are in bankruptcy under the laws of the United States or in receivership in any court of the United States or of any State, Territory, or the District of Columbia, then the liability under paragraph (*a*) of each such member of the group with respect to the period covered by such return shall not exceed such portion of the consolidated tax liability for such period as the several corporations included in the consolidated return may, subject to the approval of the Commissioner, agree upon, or, in the absence of such an agreement, an amount equal to its liability for such year computed as if a separate return had been filed.

(c) *Liability of Subsidiary After Withdrawal.*

If a subsidiary has ceased to be a member of the affiliated group, its liability under paragraph (a) shall remain unchanged, except that if such cessation occurred prior to the date upon which any deficiency is assessed and resulted from a bona fide sale of stock for fair value, the Commissioner may, if he believes that the assessment or collection of the balance of the deficiency will not be jeopardized, make assessment and collection of such deficiency from such former subsidiary in an amount not exceeding the portion thereof allocable to it upon the basis of its excess profits net income used in the computation of the deficiency.

(d) *Effect of Intercompany Agreements.*

Any agreement entered into by one or more members of the affiliated group with any other members of such group or with any other person shall in no case have the effect of reducing the liability prescribed under this section.

(e) *Liability of Transferee Not Affected.*

This section shall not be considered as extinguishing or diminishing any liability, at law or in equity, of a transferee of property of a taxpayer, including any liability under any provision of law, State or Federal, relating to liabilities pursuant to corporate dissolution or transfer or distribution of assets, whether or not in connection with a merger or consolidation.*

SEC. 33.16 **Common Parent Corporation Agent for Subsidiaries.**

(a) *Scope of Agency of Common Parent Corporation.*

Except as provided in paragraphs (b) and (c) of this section—

The common parent corporation shall be for all purposes, in respect of the tax for the taxable year for which a consolidated return is made or is required, the sole agent, duly authorized to act in its own name in all matters relating to such tax, for each corporation which during any part of such year was a member of the affiliated group. The corporations, other than the common parent, shall not have authority to act for or to represent themselves in any such matter. For example, all correspondence will be carried on directly with the common parent; notices of deficiencies will be mailed only to the common parent, and the mailing to the common parent shall be considered as a mailing to each such corporation; the common parent will file petitions and conduct proceedings before the Board of Tax Appeals, and any such petition shall be considered as having also been filed by each such corporation; the common parent will file claims for refund or credit; refunds will be made directly to and in the name of the common parent and will discharge any liability of the Government in respect thereof to any such corporation; and the common parent in its name will give waivers, give bonds, and execute closing agreements, offers in com-

promise, and all other documents, and any waiver or bond so given, or agreement, offer in compromise, or any other document so executed, shall be considered as having also been given or executed by each such corporation. Notwithstanding the provisions of this paragraph, however, any notice of deficiency, in respect of the tax for a consolidated return period, will name each corporation which was a member of the affiliated group during any part of such period, and any assessment (whether of the original tax or of a deficiency) will be made in the name of each such corporation (but a failure to include the name of any such corporation will not affect the validity of the notice of deficiency or the assessment as to the other corporations); and any notice or demand for payment, any distraint (or warrant in respect thereof), any levy (or notice in respect thereof), any notice of a lien, or any other proceeding to collect the amount of any assessment, after the assessment has been made, will name the corporation from which such collection is to be made. The provisions of this paragraph shall apply whether or not a consolidated return is made for any subsequent year, and whether or not one or more subsidiaries have become or have ceased to be members of the group at any time. Notwithstanding the provisions of this paragraph, the Commissioner may, if he deems it advisable, deal directly with any member of the group in respect of its liability, in which event such member shall have full authority to act for itself.

(*b*) *Effect of Withdrawal of Subsidiary.*

For the purpose of the assertion, assessment, and collection of any deficiency, and of a credit or refund of any amount paid by a former subsidiary as a deficiency determined under section 33.15(*c*), but for no other purpose, the agency of the common parent corporation in respect of any subsidiary which has ceased to be a member of the affiliated group shall be terminated upon the expiration of 30 days (or prior thereto if the Commissioner consents) from the date upon which such subsidiary files written notice with the Commissioner that it has ceased to be a member of the affiliated group and that it is terminating such agency. For example, if a subsidiary has ceased to be a member of the group (and if the 30-day period has expired) prior to the mailing of a notice of deficiency to the common parent, a separate notice of deficiency will be mailed in due course to the subsidiary in respect of its deficiency if it becomes necessary to enforce its liability.

(*c*) *Effect of Dissolution of Common Parent Corporation.*

If the common parent corporation contemplates dissolution, or is about to be dissolved, or if for any other reason its existence is about to terminate, it shall forthwith notify the Commissioner of such fact and designate, subject to the approval of the Commissioner, another member of the affiliated group to act as agent in its place, to the same extent and subject to the same conditions and limitations as are ap-

plicable to the common parent. If the notice thus required is not given by the common parent, the remaining members of the group may, subject to the approval of the Commissioner, designate another member of the group to act as such agent, and notice of such designation shall be given to the Commissioner. Until a notice in writing designating a new agent has been received by the Commissioner, any notice of deficiency or other communication mailed to the common parent shall be considered as having been properly mailed to the agent of the group; or, if the Commissioner has reason to believe that the existence of the common parent has terminated, he may, if he deems it advisable, deal directly with any member of the group in respect of its liability.*

SEC. 33.17 **Waivers.**

(*a*) *Effect of Waiver Given by Common Parent Corporation.*

Any consent given by the common parent corporation (or by an agent in accordance with paragraph (*c*) of section 33.16) extending the time within which an assessment may be made or distraint or proceeding in court begun, in respect of the tax for a consolidated return period, shall be applicable (1) to each corporation which was a member of the affiliated group during any part of such period (whether or not any such corporation has ceased to be a member of the group), and (2) to each corporation the income of which was included in the consolidated return, or which filed Form 1122E, for such period, even though it is subsequently determined that such corporation was not a member of the group.

(*b*) *Acceptance of Waivers from Common Parent Corporation and Alleged Subsidiary.*

In no case will a separate waiver be accepted from a corporation the income of which was included in the consolidated return (for example, a corporation which the Commissioner determines was not a member of the affiliated group), or which filed Form 1122E, unless a waiver is also obtained from the common parent corporation, or unless the Commissioner is dealing directly with such corporation to enforce its liability.*

SEC. 33.18 **Failure to Comply with Regulations.**

(*a*) *Exclusion of a Subsidiary from Consolidated Return.*

If there has been a failure to include in the consolidated return the income of any subsidiary, or a failure to file any of the forms required by these regulations, notice thereof shall be given the common parent corporation by the Commissioner, and the tax liability of each member of the affiliated group shall be determined on the basis of separate returns unless such income is included or such forms are filed within the period prescribed in such notice, or any extension thereof, or unless under section 33.11 a consolidated return is required for such year.

(*b*) *Common Parent Corporation Incorrectly Designated in Consolidated Return.*

If a consolidated return includes a corporation as the common parent and such corporation was not (under the provisions of section 730) the common parent, the tax liability of each corporation included in the return will be computed in the same manner as if separate returns had been made, unless, upon application, the Commissioner approves the making of a consolidated return, or unless under section 33.11 a consolidated return is required for such year.

(*c*) *Inclusion of One or More Subsidiaries Not Members of Affiliated Group.*

If a consolidated return includes a corporation as a subsidiary and such corporation was not a member of the affiliated group during the consolidated return period, the tax liability of such corporation will be determined upon the basis of a separate return (but see paragraph (*a*)), and the consolidated return shall be considered as including only the corporations which were members of the group during such period. If the consolidated return includes two or more corporations which are not members of the group but which constitute a separate affiliated group, the tax liability of the corporations constituting the separate group will be computed in the same manner as if separate returns had been made by such corporations, unless the Commissioner, upon application, approves the making of a consolidated return for the separate group, or unless under section 33.11 a consolidated return is required for the separate group.

(*d*) *Effect of Authorization and Consent Filed Pursuant to Notice.*

If Form 1122E is filed by any corporation, pursuant to a notice under paragraph (*a*) of this section, such corporation shall be considered for all purposes as having joined in the making of the consolidated return.

(*e*) *Allocation of Payments in the Event of Change by One or More Corporations to Separate Returns.*

In any case in which amounts have been assessed and paid upon the basis of a consolidated return and the tax liability of one or more of the corporations included in the consolidated return is to be computed in the same manner as if separate returns had been made, the amounts so paid shall be allocated between the affiliated group composed of the corporations properly included in the consolidated return and each of the corporations the tax liability of which is to be computed on a separate basis, in such manner as the corporations included in the consolidated return may, subject to the approval of the Commissioner, agree upon, or, in the absence of an agreement, upon the basis of the

excess profits net income used in the computation of the excess profits tax shown upon the consolidated return.*

COMPUTATION OF TAX, RECOGNITION OF GAIN OR LOSS, AND BASIS.

SEC. 33.30 **Computation of Tax.**

In the case of an affiliated group which makes or is required to make a consolidated excess profits tax return for any taxable year beginning after December 31, 1939, the excess profits tax liability of each corporation for the period during such year that it was a member of such group shall be computed in accordance with the provisions of section 710 upon the consolidated adjusted excess profits net income of the group (determined in accordance with these regulations) except—

(*a*) In case of abnormalities. If the affiliated group for any taxable year is subject to the provisions of section 721 (relating to abnormalities)—

(1) The tax liability of the group for the taxable year in which the whole of the abnormal income would, without regard to section 721, be includible, shall not exceed the sum of (i) the tax computed upon the consolidated adjusted excess profits net income of the group computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable year, plus (ii) the aggregate of the increase in the excess profits tax which would have resulted for each previous taxable year to which any portion of such net abnormal income is attributable, computed as if an amount equal to such portion had been included in the gross income for such previous taxable year of the corporation deriving such portion;

(2) The tax liability of the group for any future taxable year shall be the tax computed upon the consolidated adjusted excess profits net income of the group computed with the inclusion in gross income of the net abnormal income attributable to such future taxable year, but shall not exceed the sum of (i) the tax computed upon the consolidated adjusted excess profits net income of the group computed without the inclusion in excess profits net income of the portion of the net abnormal income which is attributable to such year, and (ii) the decrease in the tax for the previous taxable year in which the whole of such abnormal income would without regard to section 721 be includible, which resulted by reason of the exclusion of the whole or a part of the abnormal income from the gross income for such previous taxable year; but the amount of such decrease shall be diminished by the aggregate of the increases in the tax which have resulted for the taxable years intervening between such previous taxable year and such future taxable year because of the inclusion in gross income of the portions of such net

abnormal income attributable to such intervening years. Whether or not an abnormality exists shall be determined in the light of the aggregate business and of the collective experience during the four previous taxable years of the several members of the group.

(*b*) In case of Merchant Marine contracts. If the affiliated group for any taxable year includes a corporation subject to the provisions of section 726 (relating to corporations completing contracts under the Merchant Marine Act of 1936), the tax liability of the group shall be the tax under section 710 computed on the consolidated adjusted excess profits net income or the tax computed in accordance with the provisions of section 726(b), whichever is the lesser. The computation under section 726(b) shall be made as if the consolidated adjusted excess profits net income and the payments made or to be made to the United States Maritime Commission were the adjusted excess profits net income of and payments made or to be made by a separate corporation.

(*c*) In case of profits from mining strategic metals. If the affiliated group for any taxable year includes a corporation a portion of the income of which is, pursuant to section 731, exempt from tax by reason of such corporation having engaged in the mining of strategic metals, the tax liability of the group shall be an amount which bears the same ratio to the tax computed on the consolidated adjusted excess profits net income as the portion of the consolidated adjusted excess profits net income not exempt from tax bears to the entire consolidated adjusted excess profits net income. The portion of the consolidated adjusted excess profits net income not exempt from tax shall be determined in the same manner as if the consolidated adjusted excess profits net income were the adjusted excess profits net income of a separate corporation.

With respect to the liability of the several members of the group, see section 33.15.*

SEC. 33.31 **Bases of Tax Computation.**

(*a*) *Definitions.*

In the case of an affiliated group of corporations which makes or is required to make a consolidated excess profits tax return for any taxable year, and except as otherwise provided in these regulations—

(1) The consolidated net income shall be the combined net income of the several affiliated corporations—

(i) Minus any consolidated net operating loss deduction,

(ii) Plus any consolidated net short-term capital gain, and

(iii) Plus or minus, as the case may be, any consolidated net long-term capital gain or consolidated net long-term capital loss;

(2) The consolidated net short-term capital gain shall be the excess of the sum of the short-term capital gains of the several affiliated corporations over the sum of the short-term capital losses of such corporations;

(3) The consolidated net long-term capital gain shall be the excess of the sum of the long-term capital gains of the several affiliated corporations over the sum of the long-term capital losses of such corporations;

(4) The consolidated net long-term capital loss shall be the excess of the sum of the long-term capital losses of the several affiliated corporations over the sum of the long-term capital gains of such corporations;

(5) The consolidated net operating loss deduction shall be an amount equal to the consolidated net operating loss carry-over reduced by the amount, if any, by which the consolidated net income (computed with the exceptions and limitations provided in section 122(d)) exceeds the consolidated normal-tax net income (computed without any net operating loss deduction) but shall not exceed the amount of the consolidated normal-tax net income computed without the benefit of such deduction;

(6) The consolidated net operating loss carry-over shall be the sum of—

(i) The amount of the consolidated net operating loss, if any, for the first preceding taxable year,

(ii) The amount of the consolidated net operating loss, if any, for the second preceding taxable year reduced by the excess, if any, of the consolidated net income (computed with the exceptions and limitations provided in section 122(d)) for the first preceding taxable year over the consolidated net operating loss for the third preceding taxable year,

and, with respect to net operating losses sustained by a corporation for taxable years prior to the first taxable year in respect of which its income is included in the consolidated return—

(iii) The amount of the net operating loss, if any, sustained by such corporation for the first preceding taxable year, and

(iv) The amount of the net operating loss, if any, sustained by such corporation for the second preceding taxable year reduced by the excess, if any, of the net income of such corporation for the first preceding taxable year or, if the income of such corporation is included in the consolidated return for the first preceding taxable year, either the net income of such corporation increased by the separate net short-term and long-term capital gains of such corporation or the consolidated net income for such year (com-

puted in either case with the exceptions and limitations provided in section 122(d)), whichever is the lesser, over the net operating loss of such corporation for the third preceding taxable year;

(7) The consolidated net operating loss shall be an amount equal to the excess of the combined net operating losses of the several affiliated corporations having net operating losses (computed subject to the exceptions and limitations provided in section 122(d)) over the sum of—

(i) The combined net income of the several affiliated corporations having net income (adjusted with respect to the exceptions and limitations provided in section 122(d) in connection with the computation of net operating losses), and

(ii) The consolidated net short-term capital gain and the consolidated net long-term capital gain;

(8) The consolidated normal-tax net income shall be the consolidated adjusted net income minus the consolidated credit for dividends received;

(9) The consolidated adjusted net income shall be the consolidated net income minus the consolidated credit relating to interest on certain obligations of the United States and Government corporations;

(10) The consolidated credit for dividends received shall be an amount equal to 85 percent of the aggregate dividends, of the class with respect to which credit is allowed by section 26(b), received by the several affiliated corporations, but not in excess of 85 percent of the consolidated adjusted net income;

(11) The consolidated credit relating to interest on certain obligations of the United States and Government corporations shall be an amount equal to the aggregate of the interest, of the class with respect to which credit is allowed by section 26(a), received by the several affiliated corporations;

(12) The consolidated excess profits net income shall be the consolidated normal-tax net income increased or decreased, as the case may be, by the consolidated section 711(a) adjustment;

(13) The consolidated section 711(a) adjustment shall be the net amount of the aggregate adjustments provided by section 711(a)(1) or 711(a)(2), as the case may be, computed and determined in the case of each affiliated corporation, except as otherwise provided in (*b*) of this section, in the same manner and subject to the same conditions as if a separate return were filed, but without regard to the adjustments provided for in section 711(a)(1)(B) or 711(a)(2)(D) on account of the excess of gains over losses from certain sales or exchanges of depreciable property and section 711(a)(1)(F) or 711(a)(2)(A) on

account of dividends received, increased or decreased, as the case may be, by the sum of—

(i) The excess of the aggregate gains of the several corporations from sales or exchanges of property held for more than 18 months subject to the allowance for depreciation provided in section 23(l) over the aggregate losses of the several corporations from sales or exchanges of such property, and

(ii) The excess of the aggregate amount of the dividends received by the several corporations of the class with respect to which adjustment is provided for in section 711(a)(1)(F) or 711(a)(2)(A), as the case may be, over the consolidated credit for dividends received;

(14) The consolidated adjusted excess profits net income shall be the consolidated excess profits net income minus the sum of—

(i) A specific exemption of $5,000.

(ii) The consolidated excess profits credit, and

(iii) The consolidated excess profits credit carry-over;

(15) The consolidated excess profits credit shall be—

(i) The consolidated excess profits credit based on invested capital, or

(ii) In the case of an affiliated group one or more of the members of which would have been entitled in a separate return to an excess profits credit based on income, and subject to the provisions of section 712(c), either the consolidated excess profits credit based on income or the consolidated excess profits credit based on invested capital, whichever results in the lesser tax;

(16) The consolidated excess profits credit based on invested capital shall be 8 percent of the consolidated invested capital for the taxable year;

(17) The consolidated invested capital for the taxable year shall be the consolidated average invested capital for such year reduced by the consolidated inadmissible asset adjustment;

(18) The consolidated average invested capital for the taxable year shall be the sum of—

(i) The combined average invested capital for the taxable year of the several affiliated corporations computed in the case of each corporation without including any accumulated earnings and profits, and

(ii) The consolidated accumulated earnings and profits as of the beginning of such taxable year;

(19) The consolidated inadmissible asset adjustment shall be an amount which bears the same ratio to the consolidated average invested capital as the aggregate inadmissible assets of the several

affiliated corporations bear to the aggregate admissible and inadmissible assets of such corporations;

(20) The consolidated accumulated earnings and profits as of the beginning of the taxable year shall be an amount equal to the excess of the combined accumulated earnings and profits as of the beginning of such year of the several affiliated corporations having accumulated earnings and profits over the combined deficit in accumulated earnings and profits as of the beginning of such year of the several affiliated corporations having such deficits;

(21) The consolidated excess profits credit based on income shall be—

(i) 95 percent of the consolidated average base period net income,

(ii) Plus 8 percent of the consolidated net capital addition, or

(iii) Minus 6 percent of the consolidated net capital reduction;

(22) The consolidated average base period net income shall be, whichever is the greater—

(i) An amount which bears the same ratio to the excess of the aggregate of the consolidated base period excess profits net income for each of the consolidated base period years over the aggregate of the consolidated base period deficits in excess profits net income for any of such years, excluding the greatest, which 12 bears to the total number of months in the consolidated base period, or

(ii) An amount which bears the same ratio to the excess of the aggregate consolidated excess profits net income for each of the taxable years in the second half of the consolidated base period over the aggregate of any consolidated deficits in excess profits net income in such second half, plus one-half of the amount, if any, by which such excess in the second half of the consolidated base period exceeds such excess in the first half of such period, which 12 bears to the total number of months in the second half of the consolidated base period, but in an amount not greater than the highest consolidated excess profits net income (placed on an annual basis, when necessary) for any taxable year in the consolidated base period.

(23) For the purpose of (a)(22)(ii) of this section, the consolidated excess profits net income for any consolidated base period year ending after May 31, 1940, shall be an amount not greater than the sum of—

(i) An amount which bears the same ratio to the consolidated excess profits net income for such year as the number of months before June 1, 1940, bears to the total number of months in such taxable year, plus

(ii) An amount which bears the same ratio to the consolidated excess profits net income for the last preceding taxable year as the number of months after May 31, 1940, in the taxable year bears to the number of months in such preceding taxable year, but not in excess of the consolidated excess profits net income for such last preceding taxable year.

(iii) If the number of months in such last preceding taxable year is less than the number of months after May 31, 1940, there shall be added to the amount ascertained under (ii) an amount which bears the same ratio to the consolidated excess profits net income for the second preceding taxable year as the excess of such number of months after May 31, 1940, over the number of months in such preceding taxable year, bears to the number of months in such second preceding taxable year.

(24) The consolidated base period excess profits net income for a consolidated base period year shall be an amount equal to the combined base period excess profits net income for such year of the affiliated corporations which would have been entitled in separate returns to an excess profits credit based on income, reduced by the sum of the deficits in excess profits net income for such year, in the case of any such corporations;

(25) The consolidated base period deficit in excess profits net income for a consolidated base period year shall be an amount equal to the aggregate of the deficits for such year, in the case of the affiliated corporations which would have been entitled in separate returns to an excess profits credit based on income reduced by the combined base period excess profits net income of any such corporations for such year;

(26) The consolidated base period years shall be, as the case may be—

(i) The base period years of the common parent corporation if such common parent corporation would have been entitled in a separate return to an excess profits credit based on income, or

(ii) The four successive 12-month periods beginning on the date in 1936 corresponding to the date on which begins the first taxable year for which a consolidated return is filed if the common parent corporation would not be entitled separately to an excess profits credit based on income;

(27) The consolidated net capital addition for the taxable year shall be the excess, divided by the number of days in the taxable year, of the aggregate of the consolidated daily capital addition for each day of the taxable year over the aggregate of the consolidated daily capital reduction for each day of the taxable year;

(28) The consolidated net capital reduction for the taxable year shall be the excess, divided by the number of days in the taxable year,

of the aggregate of the consolidated daily capital reduction for each day of the taxable year over the aggregate of the consolidated daily capital addition for each day of the taxable year;

(29) The consolidated daily capital addition for any day of the taxable year shall be the combined daily capital additions of the several affiliated corporations for such day, computed without regard to the adjustment for excluded capital, reduced by the excess, if any, of the combined excluded capital of the several corporations for such day over the combined excluded capital of the several corporations for the first day following the close of the last consolidated base period year;

(30) The consolidated daily capital reduction for any day of the taxable year shall be the combined daily capital reductions of the several affiliated corporations for such day;

(31) The consolidated excess profits credit carry-over shall be the sum of—

(i) The consolidated unused excess profits credit for the first preceding taxable year,

(ii) The consolidated unused excess profits credit for the second preceding taxable year reduced by the amount, if any, by which the consolidated excess profits net income for the first preceding taxable year exceeds the sum of (A) the consolidated excess profits credit for such first preceding taxable year plus (B) the consolidated unused excess profits credit for the third preceding taxable year,

and, with respect to the unused excess profits credit of a corporation for taxable years prior to the first taxable year in respect of which its income is included in the consolidated return—

(iii) The unused excess profits credit, if any, of such corporation for the first preceding taxable year, and

(iv) The unused excess profits credit, if any, of such corporation for the second preceding taxable year reduced by—

(A) The excess, if any, of the excess profits net income of such corporation for the first preceding taxable year over the sum of the excess profits credit of such corporation for the first preceding taxable year and the unused excess profits credit of such corporation for the third preceding taxable year, or

(B) If the income of such corporation is included in the consolidated return for the first preceding taxable year, the lesser of the amount of such excess or the excess, if any, of the consolidated excess profits net income for the first preceding taxable year over the sum of the consolidated excess profits credit for the first preceding taxable year and the unused

excess profits credit of such corporation for the third preceding taxable year.

(32) The consolidated unused excess profits credit shall be the excess of the consolidated excess profits credit for any taxable year beginning after December 31, 1939, over the consolidated excess profits net income for such taxable year, computed on the basis of the excess profits credit applicable to such taxable year.

(33) The highest bracket amount of the affiliated group shall be $500,000 or the combined highest bracket amounts of the several affiliated corporations, whichever is the smaller.

(*b*) *Computations.*

(1) The net income of the several affiliated corporations shall be computed in accordance with the provisions covering the determination of net income of separate corporations, except—

(i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in these regulations as intercompany transactions),

(ii) No net operating loss deduction shall be taken into account, and

(iii) No capital gains or losses shall be taken into account.

Intercompany profits and losses which have been realized by the group through final transactions with persons other than members of the group, and intercompany transactions which do not affect the consolidated taxable net income, shall not be eliminated. As used in this paragraph, the term "net income" includes the case in which the allowable deductions of a member (not including any net operating loss deduction) exceed its gross income.

(2) For a taxable year for which a consolidated return is made or is required, the dividends received of the class with respect to which credit is allowed by section 26(b), the interest received of the class with respect to which credit is allowed by section 26(a), the short-term capital gains and losses and the long-term capital gains and losses as defined in section 117(a), the net operating loss as defined in section 122(a), the average invested capital for the taxable year, the accumulated earnings and profits or deficit in accumulated earnings and profits as of the beginning of the taxable year, the admissible and inadmissible assets, the base period excess profits net income, the deficit in excess profits net income for a base period year, the daily capital addition for any day of the taxable year, the daily capital reduction for any day of the taxable year, the excluded capital within the meaning of section 713(g)(3), and the highest bracket amount shall be computed and determined in the case of each affiliated corporation in the

same manner and subject to the same conditions as if a separate return were filed, except—

(i) In the computation of the dividends received, there shall be excluded all dividends received from other members of the affiliated group;

(ii) In the computation of short-term capital gains and losses and long-term capital gains and losses, there shall be eliminated any gains or losses arising in intercompany transactions;

(iii) In the computation of the net operating loss, the provisions of this section pertaining to the determination of net income shall apply;

(iv) In the computation of average invested capital (which, under this section, may be a minus amount), the following adjustments shall be made—

(A) There shall be excluded any accumulated earnings and profits;

(B) There shall be excluded from borrowed capital the amount of any outstanding indebtedness of the corporation owing to another member of the affiliated group;

(C) Intercompany distributions made during the taxable year shall be disregarded;

(D) Money or property paid in for stock, or as paid-in surplus, or as a contribution to capital, during the taxable year by one member of the group to another member of the group shall be disregarded;

(E) With respect to the stock of another member of the affiliated group held with a basis for determining loss upon a sale or exchange fixed, directly or indirectly, by reference to the basis of such stock in the hands of any preceding owner (not including a member of the group from which such stock was acquired during a consolidated income or excess profits tax return period), there shall be subtracted from average invested capital otherwise computed an amount equal to such basis adjusted pursuant to the provisions of section 113, except that no adjustment shall be made with respect to—

(aa) Transactions referred to in (C) and (D), and

(bb) Losses of the issuing corporation subsequent to the acquisition of such stock which losses were included in a consolidated income or excess profits tax return;

(F) In the case of a subsidiary the stock of which is held by another member of the affiliated group with a basis for determining loss upon a sale or exchange not fixed, either directly or indirectly, by reference to the basis of such stock

in the hands of any preceding owner (not including a member of the group from which such stock was acquired during a consolidated income or excess profits tax return period), there shall be excluded as of the date on which such subsidiary became a member of the affiliated group within the meaning of section 730(d) that portion of its average invested capital attributable to the shares of stock so held; there shall also be excluded, as of the date of any subsequent acquisition, that portion of its average invested capital attributable to shares of stock similarly acquired and held by other members of the affiliated group; no addition shall be made on account of money or property thereafter paid in for stock by any other member of the group or as paid-in surplus or a contribution to capital paid in with respect to shares of stock subject to the provisions of this paragraph; and no reduction shall be made on account of any distribution thereafter made to any other member of the group; stock of one member of the group indirectly acquired through the acquisition of stock of another member of the group shall, to the extent the stock of such other member is of the character described in this paragraph, be deemed to be of the same character; thus, if the P Corporation acquires for cash all the stock of the S^1 Corporation which in turn owns all the stock of the S^2 Corporation, the consolidated average invested capital of the $P–S^1–S^2$ group will be the average invested capital of the P Corporation (plus its accumulated earnings and profits and any earnings and profits accumulated by S^1 and S^2 after acquisition by P) regardless of the manner in which S^1 acquired the stock of S^2;

(G) With respect to distributions made in a consolidated income or excess profits tax return period prior to the taxable year by one member of the group to another member of the group, the average invested capital of the distributee shall not be increased by any amount in excess of the amount by which the average invested capital of the distributor or its earnings and profits, accumulated before March 1, 1913, were decreased;

(H) The average invested capital of a corporation which is a member of the affiliated group for only a part of the taxable year shall be its aggregate daily invested capital computed with the adjustments set forth in this section for each day of such taxable year during which it is a member of the group (excluding the day on which it became a member) divided by the number of days in the taxable year of the affiliated group;

(v) In the computation of accumulated earnings and profits or the deficit in accumulated earnings and profits as of the beginning of the taxable year, the following adjustments shall be made—

(A) In the case of a subsidiary the stock of which is held by other members of the affiliated group with a basis for determining loss upon a sale or exchange not fixed, either directly or indirectly, by reference to the basis of such stock in the hands of any preceding owner (not including a member of the group from which such stock was acquired during a consolidated income or excess profits tax return period), there shall be excluded as of the date on which such subsidiary became a member of the group within the meaning of section 730(d) that portion of its earnings and profits or deficit in earnings and profits previously accumulated and properly allocable to the shares of stock so held; there shall be excluded as of the date of any subsequent acquisition any earnings and profits or deficit in earnings and profits previously accumulated and properly allocable to any shares of stock similarly acquired and held by another member of the group; and stock of one member of the group indirectly acquired through the acquisition of stock of another member of the group shall, to the extent the stock of such other member is of the character described in this paragraph, be deemed to be of the same character;

(B) There shall be excluded profits and losses unrealized by the affiliated group reflected in the opening inventory of the taxable year, whether or not a consolidated return was filed for the preceding taxable years, together with all other unrealized profits and losses reflected in transactions between members of the affiliated group in prior taxable years for which a return was made or was required on a consolidated basis, either under the Second Revenue Act of 1940 or under prior income or excess profits tax Acts;

(C) No reduction shall be made with respect to any intercompany distributions made during the taxable year;

(D) With respect to distributions in stock, as defined by section 718(c)(1), made prior to the taxable year by one member of the affiliated group to another member of the group, the accumulated earnings and profits of the distributee shall not be increased in any amount in excess of that by which the sum of the average invested capital and the accumulated earnings and profits of the distributor is decreased;

(E) With respect to distributions made in a prior taxable year for which a return was made or was required on a con-

solidated basis, either under the Second Revenue Act of 1940 or under prior income or excess profits tax Acts, by one member of the group to another member of the group, the accumulated earnings and profits of the distributee shall not be increased by any amount in excess of the amount by which either the average invested capital or the earnings and profits of the distributor were decreased;

(F) If the invested capital of the affiliated group is computed pursuant to the provisions of (b)(iv)(F) of this section, proper adjustment shall be made with respect to the amount of any realizations prior to the beginning of the taxable year upon any unrealized appreciation or depreciation in assets previously reflected in consolidated average invested capital;

(G) In the case of a corporation which is a member of the affiliated group for only a part of the taxable year, the accumulated earnings and profits or the deficit in accumulated earnings and profits as of the beginning of the taxable year shall be an amount equal to its accumulated earnings and profits or its deficit in accumulated earnings and profits as of the beginning of the taxable year of the group or the beginning of the day following the day on which it becomes a member of the group, as the case may be, multiplied by the number of days of such year during which it is a member of the group (excluding the day on which it becomes a member) and divided by the total number of days in such year;

(vi) In the computation of admissible and inadmissible assets—

(A) There shall be excluded all intercompany items,

(B) Inventories shall be computed pursuant to the provisions of section 33.39, and

(C) Proper adjustment shall be made with respect to any unrealized appreciation and depreciation in assets reflected in consolidated average invested capital;

(vii) In computing base period excess profits net income or the deficit in excess profits net income for a base period year in the case of any affiliated corporation which would have been entitled in a separate return to an excess profits credit based on income—

(A) The base period years of such corporation shall be the same as the consolidated base period years;

(B) If two or more members of the affiliated group (including any component corporation of any such member as

defined in section 740 (b) and (g)) were affiliated with each other during any of the base period years within the meaning of section 730, whether or not consolidated income tax returns were filed for such years, there shall be excluded intercompany profits and losses resulting from transactions between such corporations for such years to the extent that such profits and losses would otherwise be taken into account;

(C) The short-term capital gains realized and short-term capital losses sustained by the several affiliated corporations during any of the base period years shall be treated as the short-term capital gains or losses of the group as a single corporation, and, for the purpose of computing, in the case of the several corporations, the net short-term capital loss carryover to the succeeding base period year, any net short-term capital loss of the group for the year computed pursuant to the provisions of this paragraph shall be allocated to the several corporations having net short-term capital losses for such year in amounts proportionate to such net losses;

(D) In the computation under section 713(d)(2), relating to that portion of the base period during which the corporation was not in existence—

(aa) There shall be excluded that portion of the daily invested capital of the corporation for the first day following the close of the last consolidated base period year which was paid to it by another member of the affiliated group, and

(bb) The term "preceding taxable year" means the last consolidated base period year;

(E) The amount to be excluded under section 711(b)(1)(B) on account of an excess of gains from the sale or exchange of property held for more than 18 months subject to the allowance for depreciation provided in section 23(l) over losses from such sales or exchanges shall be an amount which bears the same ratio to the excess of the aggregate of such gains over the aggregate of such losses of the several affiliated corporations as the excess of such gains over such losses of the particular corporation bears to the sum of such excesses of the several members of the group having such an excess;

(F) The amount of the adjustment under section 711(b)(1)(F) relating to repayment of processing taxes to vendees shall be computed without regard to any repayment or credit to another member of the affiliated group;

(G) In the case of a corporation which is a member of the affiliated group for only a part of the taxable year, the amount to be included with respect to each base period year shall be limited to an amount which bears the same ratio to its base period excess profits net income or the deficit in excess profits net income for such year, as the case may be, as the number of days of the taxable year during which it was a member of the group (excluding the day on which it becomes a member) bears to the total number of days in the taxable year;

(viii) In computing the daily capital addition or the daily capital reduction for any day of the taxable year—

(A) There shall be included capital additions and reductions made after, but not before, the close of the last consolidated base period year with respect to—

(aa) Affiliated corporations which would have been entitled in a separate return to an excess profits credit based on income, and

(bb) Subsidiary corporations the stock of which was acquired by other members of the affiliated group in a transaction not involving the issuance of stock by such other members;

(B) There shall be included capital additions and reductions made after December 31, 1939, with respect to all other affiliated corporations;

(C) No adjustment shall be made with respect to excluded capital;

(D) No addition shall be made for money or property paid in for stock, or as paid-in surplus, or as a contribution to capital by one member of the affiliated group to another member of the group whether or not a consolidated return was filed for the year of the transaction;

(E) No reduction shall be made with respect to distributions made to other members of the affiliated group whether or not a consolidated return was filed for the year of the distribution;

(ix) In computing excluded capital for the purpose of section 713(g)(3)—

(A) No increase or decrease shall be made by reason of transactions between members of the affiliated group occurring subsequent to the close of the last consolidated base period year, whether or not a consolidated return was filed for the year of the transaction, and

(B) The adjusted basis of stock of any members of the group held by other members of the group shall be determined without taking into account any adjustment with respect to losses of the issuing corporation subsequent to the acquisition of such stock which losses were included in a consolidated income or excess profits tax return;

(3) In no case shall there be included in the consolidated net operating loss carry-over under (a)(6) (iii) and (iv) of this section (relating to net operating losses sustained by a corporation in years prior to the first taxable year in respect of which its income is included in the consolidated return) an amount in excess of the net income of such corporation (computed with the exceptions and limitations provided in section 122(d)) included in the computation of the consolidated net income for the taxable year increased by the separate net short-term and long-term capital gains of such corporation.

(4) If a portion of the consolidated net operating loss carry-over arises pursuant to the provisions of (a)(6) (iii) or (iv) of this section (relating to losses sustained by a corporation prior to the first taxable year in respect of which its income is included in the consolidated return), the consolidated net operating loss deduction shall not be less than the amount of such portion reduced by the amount, if any, by which the net income of such corporation (computed with the exceptions and limitations provided in section 122(d)) exceeds the normal-tax net income of such corporation (computed without any net operating loss deduction but taking into account any net long-term capital loss), or, in the case of two or more such corporations, the sum of such portions so reduced.

(5) If, in the computation of the consolidated net operating loss carry-over for the second consolidated return period in respect of which the income of a corporation is included in the consolidated returns of the group, there is involved the net operating loss separately sustained by such corporation for the second preceding taxable year together with a consolidated net operating loss for the second preceding taxable year, or if, for the second consolidated return period in respect of which the income of two or more members of the affiliated group is included in the consolidated returns of the group, there are involved the net operating losses separately sustained by such corporations for the second preceding taxable year, no portion of the consolidated net income for the first preceding taxable year shall be taken into account more than once in giving effect to the provisions of (a)(6) (ii) and (iv) of this section (relating to the computation of that part of the consolidated net operating loss carry-over attributable to losses of the second preceding taxable year).

) In no case shall there be included in the consolidated excess
ts credit carry-over for any taxable year under (a)(31) (iii) and
of this section with respect to the unused excess profits credit of a
oration for years prior to the first taxable year in respect of which
ıcome is included in the consolidated return an amount in excess
ıe portion thereof which could have been availed of by such cor-
tion as an excess profits credit carry-over if a separate return had
filed for such taxable year.

) If, in the computation of the consolidated excess profits credit
y-over for the second consolidated return period in respect of
:h the income of a corporation is included in the consolidated re-
s of the group, there is involved the separate unused excess profits
it of such corporation for the second preceding taxable year to-
er with a consolidated unused excess profits credit for the second
eding taxable year, or if, for the second consolidated return period
espect of which the income of two or more members of the affili-
group is included in the consolidated returns of the group, there
nvolved the separate unused excess profits credits of such corpora-
s for the second preceding taxable year, no portion of the excess
ıe consolidated excess profits net income over the consolidated ex-
profits credit for the first preceding taxable year shall be taken
account more than once in giving effect to the provisions of
(31) (ii) and (iv) of this section (relating to the computation of
part of the consolidated excess profits credit carry-over attribut-
to unused excess profits credits of the second preceding taxable
').

) If an insurance company taxable under section 204 is included
consolidated return with other corporations taxable under section
r 14 and if, in the computation of the invested capital of such com-
y, there are included any unearned premium reserves, the portion of
:onsolidated excess profits credit based on invested capital which is
ibutable to such unearned premium reserves shall not be greater
ı the excess, if any, of the portion of the consolidated excess profits
income attributable to such company over the portion of the con-
lated excess profits credit attributable to such company computed
ıout the inclusion in invested capital of such reserves. The portion
ıe consolidated excess profits credit attributable to unearned pre-
m reserves shall be the excess of such credit computed with the
ısion of such reserves in invested capital over such credit com-
d without the inclusion of such reserves. The portion of the con-
lated excess profits net income attributable to such company shall
he excess of such net income computed with the inclusion of such
pany in the consolidated return over such net income computed
.out the inclusion of such company. The portion of the consoli-

dated excess profits credit attributable to such company computed without the inclusion of unearned premium reserves shall be the excess of such credit computed with the inclusion of such company without such reserves in invested capital over such credit computed without the inclusion of such company. With respect to any amount excluded from the consolidated excess profits credit by virtue of the provisions of this paragraph, there shall be allowed as a part of the consolidated excess profits credit carry-over in subsequent taxable years an amount not in excess of the portion of the consolidated excess profits net income attributable to such company in the subsequent taxable year over the portion of the consolidated excess profits credit attributable to such company in such subsequent year computed with the inclusion of unearned premium reserves. The portion of the consolidated excess profits credit attributable to such company computed with the inclusion of unearned premium reserves shall be the excess of such credit computed with the inclusion of such company in the consolidated return over such credit computed without the inclusion of such company.

(*c*) *Statements and Schedules for Subsidiaries.*

The statement of gross income and deductions and the several schedules required by the instructions on the return must be prepared and filed by the common parent corporation in columnar form so that the details of the items of gross income, deductions, invested capital, and credits, for each member of the affiliated group may be readily audited. Such statements and schedules shall include in columnar form a reconciliation of surplus for each such corporation, together with a reconciliation of the consolidated surplus. Consolidated balance sheets as of the beginning and close of the taxable year of the group, taken from the books of the members of the group, shall accompany the consolidated return prepared in a form similar to that required for reconciliation of surplus.

(*d*) *Net Operating Loss Deduction After Consolidated Return Period.*

A consolidated net operating loss sustained by an affiliated group during any consolidated return period of the group shall be used in computing the net income in the return of the common parent corporation (or in the consolidated return of another affiliated group of which such common parent becomes a member) for a taxable year subsequent to the last consolidated return period of the group in the same manner, to the same extent, upon the same conditions, and subject to the same limitations as if the group had been a single corporation (the common parent corporation) when such loss was sustained; but no net operating loss sustained during a consolidated return period of an affiliated group shall be used in computing the net income of a

sidiary (or the consolidated net income of another affiliated group which such subsidiary becomes a member) for any taxable year sequent to the last consolidated return period of the group. No t of any net operating loss sustained by a corporation prior to a solidated return period of an affiliated group of which such corpo- on becomes a subsidiary shall be used in computing the net income such corporation for any taxable year subsequent to the consoli- ed return period, but any part of such net operating loss which, pt for this restriction, might be so used, shall be treated as having n sustained by the common parent corporation of the group.

e) *Unused Excess Profits Credit After Consolidated Return Period.* he excess of the consolidated excess profits credit for the taxable r of an affiliated group over the consolidated excess profits net me for such year shall be used in computing the adjusted excess fits net income of the common parent corporation (or the con- dated adjusted excess profits net income of another affiliated group which such common parent becomes a member) for a taxable year sequent to the last consolidated return period of the group in the ne manner, to the same extent, upon the same conditions, and subject he same limitations as if the group had been a single corporation e common parent corporation) when such excess arose; but no sed excess profits credit for a consolidated return period of an iated group shall be used in computing the adjusted excess profits income of a subsidiary (or the consolidated adjusted excess profits income of another affiliated group of which such subsidiary be- es a member) for any taxable year subsequent to the last con- dated return period of the group.

f) Taxable Year of Less Than 12 Months.

ny period of less than 12 months for which either a separate rn or a consolidated return is filed, under the provisions of section 3, shall be considered as a taxable year, and the excess profits net me or the consolidated excess profits net income for such year, as case may be, shall be placed on an annual basis pursuant to the visions of section 711(a)(3).*

. 33.32 **Method of Computation of Income for Period of Less Than 12 Months.**

f a corporation, during the taxable year of the group, becomes a nber or ceases to be a member of an affiliated group which makes or equired to make a consolidated return for such year, the income such corporation to be included in the consolidated return shall be puted on the basis of its income as shown by its books if the ac- nts are so kept that the income for the period during which it is ember of the group can be clearly and accurately determined. If the

accounts are not so kept, the income to be included in the consolidated return shall be computed on the basis of that proportion of its income (subject to the elimination of items exempt from taxation and the addition of items not allowable as deductions in computing excess profits net income) for the full period covered by its books which the number of days for which its income is included in the consolidated return bears to the number of days in the full period covered by its books; but in the discretion of the Commissioner there may be eliminated before the proration is made items of income or deduction clearly and accurately determined to be attributable to particular periods, and, after the proration is made, such eliminated items will be added to (if items of income) or deducted from (if deductible items) the income determined by proration for the period to which such items are applicable. The credits allowable under section 13 of the Code as amended shall be given for the period to which they are properly applicable under the facts in the case.*

SEC. 33.33 **Gain or Loss From Sale of Stock or Bonds.**

Gain or loss from the sale or other disposition (whether or not during a consolidated return period), by a corporation which during any period of time (included in a taxable year beginning after December 31, 1939) has been a member of an affiliated group which makes or is required to make a consolidated return, of any share of stock or any bond or obligation issued by another corporation which during any part of such period was a member of the same group, shall be determined, and the extent to which such gain or loss shall be recognized and shall be taken into account shall also be determined, in the same manner, to the same extent, and upon the same conditions as though such corporations had never been affiliated (see sections 111 to 115, inclusive, and section 117, and the regulations thereunder), except—

(*a*) In the case of a disposition (by sale, dissolution, or otherwise) during a consolidated return period to another member of the group (see sections 33.31 and 33.37); and

(*b*) That the basis for determining the gain or loss, in the case of shares of stock held during any part of a consolidated return period, shall be determined in accordance with section 33.34; and

(*c*) As provided in sections 33.35 and 33.36 (imposing certain limitations upon losses otherwise allowable upon sales of stock or bonds).*

SEC. 33.34 **Sale of Stock—Basis for Determining Gain or Loss.**

(*a*) *Scope of Section.*

For the purpose of computing excess profits net income, this section prescribes the basis for determining the gain or loss upon any sale or other disposition (hereinafter referred to as "sale") by a corpora-

which is (or has been) a member of an affiliated group which
es (or has made) a consolidated income or excess profits tax return
the taxable year 1929 or any subsequent taxable year, of any share
tock issued by another member of such group (whether issued
re or during the period that it was a member of the group and
ther issued before, during, or after the taxable year 1929), and
by the selling corporation during any part of a period for which
nsolidated return is made or required under these regulations.
or the basis in the case of sales which do not break the affiliation,
paragraph (*b*).
or the basis in the case of sales which break the affiliation and
ch are made within the period during which the selling corpora-
is a member of the affiliated group (whether or not during a con-
dated return period), see paragraph (*e*).
or the basis in the case of sales made after the selling corporation
ceased to be a member of the affiliated group, see paragraph (*d*).
or the basis in the case of sales of bonds, see section 33.35.
b) *Sales Which Do Not Break Affiliation.*
f, notwithstanding any such sale, the issuing corporation remains
ember of the affiliated group, the basis shall be determined and
usted in the same manner as if the selling corporation and the
ing corporation had never been members of an affiliated group.
see section 33.38(*b*).
c) *Sales Which Break Affiliation Made While Selling Corporation
lember of Affiliated Group.*
f the sale is made within a period during which the selling corpo-
on is a member of the affiliated group (whether or not during a
solidated return period), and if, as a result of such sale, the issuing
poration ceases to be a member of the group, the basis shall be
ermined as follows:
1) The aggregate bases of all shares of stock of the issuing corpo-
on held by each member of the affiliated group (exclusive of the
ing corporation) immediately prior to the sale shall be determined
arately for each member of the group and adjusted in accordance
h the Code, but without regard to any adjustment under the last
tence of section 113(a)(11) with respect to losses of the issuing
poration sustained by such corporation after it became a member
he affiliated group and included in a consolidated income or excess
fits tax return of the group.
2) From the combined aggregate bases as determined in subpara-
ph (1) there shall be deducted the sum of—

(i) All losses of such issuing corporation sustained during tax-
able years for which consolidated income tax returns were made
or were required (including only the taxable year 1929 and subse-

quent taxable years) after such corporation became a member of the affiliated group and prior to the sale of the stock to the extent that such losses could not have been availed of by such corporation as a net loss or net operating loss in computing its net income for such taxable years if it had made a separate return for each of such years,

(ii) With respect to each of such taxable years for which consolidated returns were made or were required both for income and for excess profits tax purposes, the excess, if any, of all losses of such issuing corporation for such year, properly adjusted in the computation of consolidated excess profits net income, over the amount of such losses for such year computed under (i) to the extent that such excess could not have been availed of by such corporation as a net operating loss in computing its excess profits net income for such taxable years if it had made a separate excess profits tax return for each of such years, and

(iii) With respect to each of such taxable years for which consolidated returns were made or were required for excess profits tax purposes only, all losses of such issuing corporation for such year, properly adjusted in the computation of consolidated excess profits net income, to the extent that such losses could not have been availed of by such corporation as a net operating loss in computing its excess profits net income for such taxable years if it had made a separate excess profits tax return for each of such years.

For any taxable year (whether beginning prior to January 1, 1940, or on or after such date) in which the group sustained a consolidated loss not availed of in subsequent years as a deduction under net loss or net operating loss provisions, the amount deducted under this paragraph shall be reduced by an amount equal to that proportion of such consolidated loss which the loss of the issuing corporation for the year in which such loss was sustained bears to the aggregate losses of the members of the group for such year.

(3) The sum of the aggregate bases of all shares of stock, after making the deduction under subparagraph (2), shall then be apportioned among the members of the affiliated group which held stock of the issuing corporation, by allocating to each such member that proportion of the sum of the aggregate bases so reduced which the aggregate basis of the stock in the issuing corporation held by such member bears to the sum of the aggregate bases.

(4) The aggregate basis as determined under subparagraph (3) for each member of the affiliated group shall then be equitably apportioned among the several classes of stock of the issuing corporation

by such member according to the circumstances of the case—
narily by allocating to each class of such stock that proportion of
ıggregate basis which the basis of each class of such stock held by
the time of the sale is to the sum of the bases of the several classes
ıch stock held by it.
) The basis of each share of stock of each class held by a member
ıe affiliated group shall then be determined by dividing the basis
ɔrtioned to such class under subparagraph (4) by the total number
ıares of such class held by it.
l) *Sales After Selling Corporation Has Ceased to Be Member of*
iated Group.
' the sale is made after the selling corporation has ceased to be a
ıber of the affiliated group, such basis shall be determined in ac-
ance with paragraph (c) of this section, except that—
.) The aggregate bases (under paragraph (c)(1)) shall be deter-
ed for all shares of the issuing corporation held by each member
he group immediately prior to the time the selling corporation
ed to be a member of the group (rather than immediately prior to
sale);
2) The allocations (under paragraph (c)(3)) shall be made to
ı member of the group which held stock of the issuing corpora-
immediately prior to the time the selling corporation ceased to be
ember of the group (rather than to the members holding such
k at the time of the sale); and
3) The basis of each share of stock held by the selling corporation
ermined, as above, as of the time the selling corporation ceased to
member of the group) shall then be adjusted in accordance with
Code (see, particularly, sections 111 to 115, inclusive), in order to
rmine the basis at the time of the sale.
:) *Definition of "Loss," "Consolidated Loss," and "Net Loss" or*
t Operating Loss."
s used in this section the term "loss" means the excess over the
s income of the issuing corporation of the sum of its allowable
ıctions (not including any net loss or net operating loss deduc-
) plus the proportionate part properly attributable to such cor-
ıtion of the credits relating to interest on certain Government
gations and dividends received allowable in computing consoli-
d normal-tax net income, the consolidated special class net income,
ɔnsolidated net income subject to tax; the term "consolidated loss"
ns the excess of the sum of the losses, separately computed, over
sum of the normal-tax net income, the special class net income, or
net income subject to tax, separately computed, of the several
ıbers of the affiliated group, determined in accordance with the
'isions of the Code, or the Revenue Act, and pursuant to the pro-

visions of consolidated returns regulations, applicable to the period; and the term "net loss" or "net operating loss" means the net loss or net operating loss, as the case may be, determined in accordance with the provisions of the Code, or the Revenue Act, and pursuant to the provisions of consolidated returns regulations, applicable to the period.*

SEC. 33.35 **Sale of Bonds—Basis for Determining Gain or Loss.**

In the case of a sale or other disposition by a corporation, which is (or has been) a member of an affiliated group which makes (or has made) a consolidated income or excess profits tax return for the taxable year 1929 or any subsequent taxable year, of bonds or obligations issued by another member of such group (whether or not issued while it was a member of the group and whether issued before, during, or after the taxable year 1929), the basis of each bond or obligation, for determining the gain or loss upon such sale or other disposition, shall be determined in accordance with the Code (see, particularly, section 113), but the amount of any loss otherwise allowable shall be decreased by the excess (if any) of the aggregate of the deductions computed under paragraph (c) (2) of section 33.34 over the sum of the aggregate bases of the stock of the issuing corporation as computed under paragraph (*c*) (1) or (*d*), as the case may be, held by the members of the group. (See, also, section 33.40, relating to disallowance of loss upon intercompany bad debts.)*

SEC. 33.36 **Limitation on Allowable Losses on Sale of Stock or Bonds.**

(*a*) *General Rule.*

No loss shall be allowed under section 33.33, 33.34, or 33.35 upon the sale or other disposition of stock or bonds or obligations to the extent that such loss is attributable to (1) transfers of assets within the affiliated group (by sale, gift, or otherwise) without consideration or at markedly fictitious values, during the period in which the corporations were affiliated (whether or not a consolidated return was made and whether before, during, or after the first taxable year beginning after December 31, 1939), or (2) a distribution during a period in which the corporations were affiliated of earnings or profits accumulated prior to the date upon which the distributing corporation became a member of the group.

(*b*) *Qualification of General Rule.*

Paragraph (a) of this section shall not be considered as in any way limiting the operation of the provisions of the Code relating to the basis for determining gain or loss upon the sale or other disposition of property (see sections 111 to 115, inclusive), but as being in amplification of and not in substitution for such provisions; subject, however, to this qualification: that to the extent that the transfers of assets re-

ed to in paragraph (*a*) are taken into account under the terms of Code in making adjustments in the basis, such transfers will not aken into account in denying losses under paragraph (*a*).*

. 33.37 **Liquidations—Recognition of Gain or Loss.**

a) *During Consolidated Return Period.*

ain or loss shall not be recognized upon a distribution during a solidated return period, by a member of an affiliated group to an- er member of such group, in cancellation or redemption of all or any tion of its stock, except—

1) Where such distribution is in complete liquidation and redemp- n of all of the stock (whether in one distribution or a series), falls hout the provisions of section 112(b)(6), and is the result of a a fide termination of the business and operations of such member he group, in which case it shall be treated as a sale of the stock, the ustments specified in sections 33.34 and 33.35 will be made, and tion 33.36 will be applicable; and

2) Where such a distribution without the provisions of section (b)(6) is one made in cash in an amount in excess of the adjusted is of the stock.

Vhen the business and operations of the liquidated member of the iated group are continued by another member of the group, it ll not be considered a bona fide termination of the business and rations of the liquidated member. (With respect to the acqui- on of its bonds by the issuing company, see section 33.41(*b*).)

'or the purpose of determining whether an affiliated corporation iving property in a liquidating distribution qualifies under the visions of section 112(b)(6)(A), the aggregate amount of the k of the liquidated corporation owned by the several members he affiliated group on the date of the adoption of the plan of liqui- ion and at all times subsequent thereto and prior to the receipt of property in liquidation shall be considered as owned by the ributee.

b) *After Consolidated Return Period.*

ny such distribution after a consolidated return period, whether omplete or partial liquidation, except a complete liquidation within provisions of section 112(b)(6), shall be treated as a sale of the k, and the adjustments specified in sections 33.34 and 33.35 will nade, and section 33.36 will be applicable.*

. 33.38 **Basis of Property.**

a) *General Rule.*

ubject to the provisions of paragraphs (*b*) and (*c*) and except otherwise provided in section 33.34, the basis during a consolidated rn period for determining the gain or loss from the sale or other position of property, or upon which exhaustion, wear and tear,

obsolescence, amortization, and depletion are to be allowed, shall be determined and adjusted in the same manner as if the corporations were not affiliated (see sections 111 to 115, inclusive), whether such property was acquired before or during a consolidated return period. Such basis immediately after a consolidated return period (whether the affiliation has been broken or whether the privilege of making a consolidated return is not exercised) shall be the same as immediately prior to the close of such period.

(*b*) *Intercompany Transactions.*

The basis prescribed in paragraph (*a*) shall not be affected by reason of a transfer during a consolidated return period, other than upon liquidation as provided in (*c*) (whether by sale, gift, dividend, or otherwise), from a member of the affiliated group to another member of such group.

(*c*) *Basis After Liquidation.*

(1) Where property is acquired during a taxable year beginning after December 31, 1939, upon a distribution described in section 33.37(*a*) in which gain or loss is recognized to the distributee, the basis of such property shall be its fair market value at date of acquisition.

(2) Where property is acquired during a taxable year beginning after December 31, 1939, upon a distribution in which gain or loss to the distributee is not recognized pursuant to the provisions of section 112(b)(6), the basis of such property shall be the same as it would be in the hands of the transferor.

(3) Where property is acquired during a taxable year beginning after December 31, 1939, upon a distribution (not a complete liquidation within the provisions of section 112(b)(6)) in which gain or loss to the distributee is not recognized as provided in section 33.37(*a*), the basis of such property shall be the same as the basis (determined in accordance with sections 111 to 115, inclusive, and section 33.34) of the stock exchanged therefor, adjusted—

(i) For the transfer of assets within the affiliated group by the distributing corporation (by sale, gift, or otherwise) without consideration or at markedly fictitious values, during the period for which the corporations were affiliated (whether or not a consolidated return was made and whether before, during, or after the first taxable year beginning after December 31, 1939);

(ii) For distributions during a period in which the corporations were affiliated of earnings or profits accumulated prior to the date upon which the distributing corporation became a member of the group; and

(iii) For cash received in the distribution.

l) Basis Not Affected by Acquisition or Sale of Stock.

either the acquisition of stock of a corporation nor its sale or other osition shall affect the basis of the property of such corporation determining gain or loss or upon which exhaustion, wear and tear, olescence, amortization, and depletion are to be allowed.*

. 33.39 **Inventories.**

i) Consolidated Return For First Year of Affiliation.

f the income of an affiliated corporation is included in a consolidated rn for the period immediately following the date upon which such oration became a member of the affiliated group, the value of its ning inventory to be used in computing the consolidated net income l be the proper value of the closing inventory used in computing et income for the preceding taxable year.

) Consolidated Return After Separate Return by Affiliates.

f a corporation which is a member of the affiliated group for the consolidated return period was a member of the group in the eding taxable year, the value of its opening inventory to be used omputing the consolidated net income for the first consolidated rn period shall be the proper value of the closing inventory used omputing its net income for the preceding taxable year decreased he amount of profits or increased in the amount of losses reflected such inventory which arose in transactions between members of affiliated group and which have not been realized by the group ough final transactions with persons other than members of the up.

) Separate Returns Made After Consolidated Returns.

f a corporation which was a member of an affiliated group in a solidated return period makes or is required to make a separate rn for the succeeding taxable year, the value of its opening inven- to be used in computing its net income for such succeeding tax- year shall be the proper value of its closing inventory used in puting consolidated net income for the last consolidated return od.

d) Base Period Years.

or each of the base period years, proper adjustment with respect nrealized profits or losses in transactions between members of the iated group (including any component corporation of any such nber as defined in section 740 (b) and (g)) which were affiliated n each other during such year within the meaning of section 730 l be made in the opening and closing inventories of each such iated corporation which would have been entitled in a separate rn to an excess profits credit based on income.*

SEC. 33.40 **Bad Debts.**

(*a*) *Deduction During Consolidated Return Period.*

No deduction shall be allowed during a consolidated return period to any member of the affiliated group on account of worthlessness in whole or in part of any obligation (including accounts receivable, bonds, notes, debts and claims of whatsoever nature) of any other member of the group.

(*b*) *Limitation on Allowance After Consolidated Return Period.*

The rules applicable to the allowance of losses upon the sale of bonds shall be applicable to the allowance after the consolidated return period as bad debts of obligations (including accounts receivable) of a member of an affiliated group acquired in any way by another member of the group prior to or during the consolidated return period. (See section 33.36.)*

SEC. 33.41 **Sale and Retirement by Corporation of its Bonds.**

(*a*) *Issued at Discount or Premium.*

If a corporation which during any taxable year (beginning after December 31, 1939) has been a member of an affiliated group which makes or is required to make a consolidated return, has issued its bonds at a discount or premium (whether before, during, or after the first taxable year beginning after December 31, 1939, and whether or not during a consolidated return period), deduction will be allowed for the amortization of the discount, and income included for the amortization of the premium, in the same manner, to the same extent, and upon the same conditions as if the corporation had never been affiliated, except that no deduction for amortization of discount shall be allowed, and no income shall be included for amortization of premium, during a period for which a consolidated return is made, on bonds of one member of the group owned by another member of the group.

(*b*) *Acquisition of Bonds by Issuing Company.*

If a corporation which during any taxable year (beginning after December 31, 1939) has been a member of an affiliated group which makes or is required to make a consolidated return, acquires its bonds (whether or not from another member of such group and whether or not during a consolidated return period), gain or loss shall be recognized in the same manner, to the same extent, and upon the same conditions as if the corporation had never been affiliated, except that, if such bonds are acquired from another member of the group during a consolidated return period, in determining the gain or loss to the issuing company from such acquisition, the basis thereof to such other member of the group shall be deemed the purchase price.*

SEC. 33.42 **Capital Loss Limitations and Carry-Over.**

The provisions of sections 23(g) and (k), 117(d) and (e), and 122(d) with respect to gains and losses from sales or exchanges of capital assets shall be applied, in respect of such gains and losses sustained during a consolidated return period, as if the affiliated group were the taxpayer.

With respect to a net short-term capital loss sustained by a corporation in a year prior to the first consolidated return period in respect of which the income of such corporation is included in the consolidated return, such loss (in an amount not in excess of the net income of such corporation for such year or in excess of the net short-term capital gain of such corporation for the first consolidated return period) shall, for the purposes of section 117(e), relating to a net short-term capital loss carry-over, be treated as if such net short-term capital loss had been sustained by the affiliated group.

A consolidated net short-term capital loss sustained by the affiliated group during the last consolidated return period of the group (in an amount not in excess of the consolidated net income for such year) shall be treated in the succeeding taxable year, subject to the exception provided in section 117(e), as a short-term capital loss of the common parent corporation. No portion of any consolidated net short-term capital loss sustained during a consolidated return period of an affiliated group shall be used in computing short-term capital losses of a subsidiary for any subsequent taxable year.*

SEC. 33.43 **Credit for Foreign Taxes.**

The credit allowed to an affiliated group for taxes paid or accrued during the consolidated return period to any foreign country or to any possession of the United States (under section 131 as made applicable and qualified by section 729) shall be computed and allowed as if the affiliated group were the taxpayer, and as if the aggregate taxes paid by the several members of the group and the credits allowed for income tax purposes with respect to such payments were payments made by and credits allowed to the group.*

SEC. 33.44 **Methods of Accounting.**

(*a*) *In General.*

For the purpose of determining consolidated excess profits net income, all members of the affiliated group shall adopt that method of accounting which clearly reflects the consolidated excess profits net income. A method of accounting which does not treat with reasonable consistency all items of gross income and deductions of the various members of the group shall not be regarded as clearly reflecting the consolidated excess profits net income. For example, one member of the group will not be permitted to report items of income or deduc-

tions on the cash method of accounting, while another member of the same group reports the same or similar items on the accrual method. The provisions of this paragraph are subject to the exceptions stated in paragraph (*b*).

(*b*) *Combination of Methods.*

For the purpose of determining consolidated excess profits net income, if the members of an affiliated group have established different methods of accounting, each member may retain such method with the consent of the Commissioner, provided that the consolidated excess profits net income is clearly reflected, and, provided further that intercompany transactions affecting consolidated excess profits net income, between members of the group shall be eliminated and adjustments on account of such transactions shall be made with reference to a uniform method of accounting, to be selected by the members of the group with the consent of the Commissioner.

(*c*) *Change to Accrual Method.*

In the case of a corporation which previously has reported its income (whether in a separate or a consolidated return) in accordance with a method other than the accrual method and is required under this section to report its income for the taxable year under the accrual method, items of income which accrued prior to the taxable year but were properly omitted in the determination of net income under the method of accounting formerly followed shall be included in the income for the taxable year of the change in accounting method, and items of income which were properly included in the determination of net income under the method of accounting formerly followed shall not be included in the income for the taxable year of the change or any subsequent year. In such a case, deductions which accrued prior to the taxable year but which were properly omitted in the determination of net income under the method of accounting formerly followed shall be allowed for the taxable year of the change in accounting method, and deductions which were properly included in the determination of net income under the method of accounting formerly followed shall not be allowed in the determination of net income for the taxable year of change or any subsequent year.*

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved March 14, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register March 14, 1941, 8.31 p. m.)

INCOME TAX REGULATIONS [103] AND EXCESS PROFITS TAX REGULATIONS [109], AMENDED.

1941–18–10702
T. D. 5045

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PARTS 19 AND 30.—INCOME TAX AND EXCESS PROFITS TAX.

Regulations 103 and 109 amended to conform to the Excess Profits Tax Amendments of 1941.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

In order to conform Regulations 103 [Part 19, Title 26, Code of Federal Regulations, 1940 Sup.] and Regulations 109 [Part 30, Title 26 of such Code, 1941 Sup.] to the Excess Profits Tax Amendments of 1941 (Public law 10, Seventy-seventh Congress), approved March 7, 1941, such regulations are amended as follows:

REGULATIONS 103.

PARAGRAPH 1. There is inserted immediately preceding section 19.23(a)–1 the following:

SEC. 10. CAPITALIZATION OF ADVERTISING, ETC., EXPENDITURES. (Excess Profits Tax Amendments of 1941.)

* * * * *

(b) AMENDMENT TO CHAPTER 1.—Section 23(a) of the Internal Revenue Code is amended by adding at the end of a new paragraph, applicable to taxable years beginning after December 31, 1939, reading as follows:

"(3) EXPENDITURES FOR ADVERTISING AND GOOD WILL.—If a corporation has, for the purpose of computing its excess profits credit under chapter 2E, claimed the benefits of the election provided in section 733, no deduction shall be allowable under paragraph (1) to such corporation for expenditures for advertising or the promotion of good will which, under the rules and regulations prescribed under section 733(a), may be regarded as capital investments."

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

PAR. 2. There is inserted immediately after section 19.23(a)–13 the following new section:

SEC. 19.23(a)–14. *Expenditures for advertising or the promotion of good will.*—A corporation which has, for the purpose of computing its excess profits credit, elected under section 733 to charge to capital account expenditures for advertising or the promotion of good will which may be regarded as capital investments and which were deducted for taxable years beginning after December 31, 1935, and prior to January 1, 1940, may not deduct similar expenditures for taxable years beginning after December 31, 1939. Such a taxpayer has the

burden of proving that expenditures for advertising or the promotion of good will which it seeks to deduct for such later taxable years may not be regarded as capital investments under the provisions of the regulations prescribed under section 733. For rules for determining what expenditures for advertising or the promotion of good will may be regarded as capital investments, and for information required to be submitted with respect to such expenditures, see section 30.733–2 of Regulations 109.

REGULATIONS 109.

PAR. 3. The following is inserted immediately preceding section 30.710–1:

PUBLIC LAW 10, SEVENTY-SEVENTH CONGRESS, APPROVED MARCH 7, 1941.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Excess Profits Tax Amendments of 1941".

SEC. 2. UNUSED EXCESS PROFITS CREDIT. (Excess Profits Tax Amendments of 1941.)

(a) Section 710(b)(3) of the Internal Revenue Code is amended to read as follows:

"(3) UNUSED EXCESS PROFITS CREDIT.—The amount of the excess profits credit carry-over for the taxable year, computed in accordance with subsection (c)."

(b) COMPUTATION OF EXCESS PROFITS CREDIT CARRY-OVER.—Section 710 of the Internal Revenue Code is amended by adding at the end thereof the following new subsection:

"(c) EXCESS PROFITS CREDIT CARRY-OVER.—

"(1) DEFINITION OF UNUSED EXCESS PROFITS CREDIT.—The term 'unused excess profits credit' means the excess, if any, of the excess profits credit for any taxable year beginning after December 31, 1939, over the excess profits net income for such taxable year, computed on the basis of the excess profits credit applicable to such taxable year.

"(2) COMPUTATION OF EXCESS PROFITS CREDIT CARRY-OVER.—The excess profits credit carry-over for any taxable year shall be the sum of the following:

"(A) The unused excess profits credit for the first preceding taxable year; and

"(B) The unused excess profits credit for the second preceding taxable year reduced by the amount, if any, by which the excess profits net income for the first preceding taxable year exceeds the sum of—

"(i) the excess profits credit for such first preceding taxable year, plus

"(ii) the unused excess profits credit for the third preceding taxable year."

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

PAR. 4. Section 30.710–2 is amended as follows:

(A) That portion of the first paragraph following item (*b*) is amended to read:

(c) A carry-over of the unused excess profits credit (as defined in section 710(c)(1)) for the two preceding excess profits tax taxable years, computed as provided in section 710(c)(2).

In the case of a taxpayer which is entitled to use the excess profits credit based on income or the excess profits credit based on invested capital, whichever credit results in the lesser excess profits tax, and which has not disclaimed the use of either credit, the term "excess profits credit applicable to such taxable year,"

within the meaning of section 710(c)(1), means whichever credit results in the larger unused excess profits credit.

(B) There is inserted at the end of the section the following:

The computation of the excess profits credit carry-over provided in section 710(c)(2) may be illustrated by the following example:

Example. The Y Corporation has for the years 1940, 1941, 1942, and 1943 excess profits net income and applicable excess profits credits as follows:

	1940	1941	1942	1943
Excess profits net income	$50,000	$100,000	$200,000	$210,000
Applicable excess profits credit	80,000	150,000	160,000	150,000

The excess profits credit carry-over for the year 1943 is $40,000, computed as follows:

The factors to be taken into consideration in computing such carry-over are:

(1) The unused excess profits credit for the first preceding taxable year (1942)	None
(2) The unused excess profits credit for the second preceding taxable year (1941)	$50,000
(3) The excess profits net income for the first preceding taxable year (1942)	200,000
(4) The applicable excess profits credit for the first preceding taxable year (1942)	160,000
(5) The unused excess profits credit for the third preceding taxable year (1940)	30,000

The carry-over is the amount of item (1) and item (2) reduced by the amount by which item (3) exceeds the sum of items (4) and (5). The amount by which item (3) exceeds the sum of items (4) and (5) is $10,000 ($200,000 minus ($160,000 plus $30,000)). Item (2) reduced by such excess is $40,000. Item (2) so reduced plus item (1) is $40,000 ($40,000 plus 0).

PAR. 5. The following is inserted immediately preceding section 30.711(a)-1:

SEC. 12. ADMISSIBLE ASSETS OF DEALERS IN SECURITIES. (Excess Profits Tax Amendments of 1941.)

* * * * *

(b) Section 711(a)(2)(A) is amended by inserting after "companies" a period and the following: "This subparagraph shall not apply to dividends on stock which is not a capital asset".

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

PAR. 6. Section 30.711(a)-1 is amended by striking out the fourth sentence and inserting in lieu thereof the following:

As to corporations entitled to use the excess profits credit based on income or the excess profits credit based on invested capital, whichever credit results in the lesser excess profits tax, and corporations required to use the excess profits credit based on invested capital, see sections 712 and 741.

PAR. 7. Section 30.711(a)-3 is amended as follows:

(A) That portion of the second sentence preceding the first colon is amended to read as follows:

Under section 711(a)(2) no adjustment of normal-tax net income shall be made for dividends received on stock which is not a capital asset as defined in section 117, such as stock held primarily for sale to customers by a dealer in securities.

Otherwise the adjustments are the same as the adjustments provided in section 711(a)(1) except that the following additional adjustments are required to be made:

(B) Subdivision (*b*) of the first paragraph is amended to read as follows:

(*b*) There shall be subtracted from the normal-tax net income the amount of dividends received from foreign corporations on stock which is a capital asset, except dividends (actual or constructive) on stock of foreign personal-holding companies.

(C) Immediately following subdivision (*b*) of the example there is added a new subdivision reading as follows:

(*c*) The corporation held as a capital asset the stock on which the dividends were received.

PAR. 8. The following is inserted immediately preceding section 30.711(b)-1:

SEC. 3. ABNORMAL DEDUCTION IN BASE PERIOD. (Excess Profits Tax Amendments of 1941.)

Sections 711(b)(1) (G), (H), and (I), of the Internal Revenue Code are amended to read as follows:

"(G) Dividends Received.—The credit for dividends received shall apply, without limitation, to dividends on stock of domestic corporations;

"(H) Payment of Judgments, and So Forth.—Deductions attributable to any claim, award, judgment, or decree against the taxpayer, or interest on any of the foregoing, if abnormal for the taxpayer, shall not be allowed, and if normal for the taxpayer, but in excess of 125 per centum of the average amount of such deductions in the four previous taxable years, shall be disallowed in an amount equal to such excess;

"(I) Intangible Drilling and Development Costs.—Deductions attributable to intangible drilling and development costs paid or incurred in or for the drilling of wells or the preparation of wells for the production of oil or gas, and for development costs in the case of mines, if abnormal for the taxpayer, shall not be allowed, and if normal for the taxpayer, but in excess of 125 per centum of the average amount of such deductions in the four previous taxable years, shall be disallowed in an amount equal to such excess; and

"(J) Abnormal Deductions.—Under regulations prescribed by the Commissioner, with the approval of the Secretary, for the determination, for the purposes of this subparagraph, of the classification of deductions—

"(i) Deductions of any class shall not be allowed if deductions of such class were abnormal for the taxpayer, and

"(ii) If the class of deductions was normal for the taxpayer, but the deductions of such class were in excess of 125 per centum of the average amount of deductions of such class for the four previous taxable years, they shall be disallowed in an amount equal to such excess.

"(K) Rules for Application of Subparagraphs (H), (I), and (J).—For the purposes of subparagraphs (H), (I), and (J)—

"(i) If the taxpayer was not in existence for four previous taxable years, then such average amount specified in such subparagraphs shall be determined for the previous taxable years it was in existence and the succeeding taxable years which begin before the beginning of the taxpayer's second taxable year under this subchapter. If the number of such succeeding years is greater than the number necessary to obtain an aggregate of four taxable years there shall be omitted so many of such succeeding years, beginning with the last, as are necessary to reduce the aggregate to four.

"(ii) Deductions shall not be disallowed under such subparagraphs unless the taxpayer establishes that the abnormality or excess is not a consequence of an increase in the gross income of the taxpayer in its base period or a decrease in the amount of some other deduction in its base period, and is not a consequence of a change at any time in the type, manner of operation, size, or condition of the business engaged in by the taxpayer.

"(iii) The amount of deductions of any class to be disallowed under such subparagraphs with respect to any taxable year shall not exceed the amount by which the deductions of such class for such taxable year exceed the deductions of such class for the taxable year for which the tax under this subchapter is being computed."

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

PAR. 9. Section 30.711(b)–1 is amended as follows:

(A) By striking out the last sentence in the first paragraph.

(B) By striking out the paragraph following the first example and inserting in lieu thereof the following:

In computing the tax for the purpose of the adjustments required by section 711(b)(1)(A), the normal-tax net income or special-class net income for each base period year shall be that used in the determination of the average base period net income.

(C) By changing the last paragraph to read as follows:

In connection with the adjustments required to be made by section 711(b)(1)(H), (I), and (J), see section 30.711(b)–2.

PAR. 10. The following is inserted immediately after section 30.711(b)–1:

SEC. 30.711(b)–2. *Abnormal deductions in base period.*—Adjustments in the excess profits net income for a taxable year in the base period are required in order to disallow deductions of a class which is abnormal for the taxpayer, and to disallow the amount by which deductions of a class normal for the taxpayer exceed 125 per cent of the average amount of deductions of such class for the four previous taxable years. If the taxpayer was not in existence for four previous taxable years, then the average amount of deductions of any class shall be determined for the previous taxable years during which it was in existence and the succeeding taxable years which begin before the beginning of the taxpayer's second excess profits tax taxable year. If the number of such succeeding years is greater than the number necessary to obtain an aggregate of four taxable years there shall be omitted so many of such succeeding years, beginning with the last, as are necessary to reduce the aggregate to four. For example, in the case of a corporation coming into existence on January 1, 1938, and making its income tax returns on the calendar year basis, the amount of deductions of any class which may be disallowed for the taxable year 1939 may be determined from the average of the deductions for the taxable years 1938 and 1940. The taxable year 1941 is the taxpayer's second excess profits tax taxable year and therefore may not be used.

A class of deductions is abnormal only if the taxpayer had no deductions of that class in the taxable years prescribed for determining average deductions.

The taxpayer must establish that the abnormality or excessiveness of the deduction is not a consequence of an increase in the gross income of the taxpayer in its base period or a decrease in the amount of some other deduction in its base period, and is not a consequence of a change at any time in the type, manner of operation, size, or condition of the business engaged in by the taxpayer. For example, if in 1939 the deductions of an airplane manufacturer for wages were in excess of 125 per cent of the average of such deductions for the four previous taxable years because of a training program for mechanics instituted by the corporation in 1939 to provide for an expansion in operations, no part of the

deductions will be disallowed. If a corporation distributes its product through agents paid commissions on gross sales, and due to a rise in the price of the product, both the amount of gross income and the amount of deductions for commissions increased, any resulting abnormal amount of deductions for commissions will not be disallowed. If the X Gasoline Corporation in 1938 and all prior years deducted gasoline taxes paid by it as a business expense under section 23(a), but in 1939 included such taxes for that year in its deductions for taxes paid under section 23(c) so as to increase its deductions for taxes paid for 1939 to an amount in excess of 125 per cent of its average deductions of the same class for the four previous taxable years, the abnormal amount of such deduction for 1939 will not be disallowed. As to advertising expenditures, the provisions of section 733 apply before any determinations are made under this section. See section 30.733–3.

In order for the deduction of any class to be disallowed, the deductions of such class for the taxable year in the base period must exceed the deductions of the same class for the taxable year for which the excess profits tax is being computed, and any amount which may be disallowed shall be no greater than the amount by which the deductions of such class for the base period taxable year exceed the deductions of the same class for the taxable year for which the excess profits tax is being computed. For example, if a corporation in the base period taxable year 1938 had a deduction of $200,000 and its average of deductions of the same class for the four previous taxable years was $100,000, the amount of $75,000 ($200,000 minus 125 per cent of $100,000) may be disallowed, but only if the deductions of this class in 1938 exceed by this or a greater amount the deductions of the same class in the taxable year for which the excess profits tax is being computed. If the tax is computed for 1940 and the deductions of this class for 1940 are $100,000, the full $75,000 is disallowed for the taxable year 1938. If for 1941 the deductions of this class are $125,000, the full $75,000 may again be disallowed for the taxable year 1938 in computing the excess profits tax for 1941. However, if for 1942 the deductions of this class are $150,000, only $50,000 will be disallowed for the taxable year 1938 in determining the excess profits credit based on income for use against the excess profits net income for 1942.

(*a*) *Classification of deductions.*—Section 711(b)(1) (H) and (I) sets forth specific classes of deductions, the amount of which in any base period taxable year may be totally disallowed if abnormal for the taxpayer or disallowed to the extent of the excess over 125 per cent of the average of such class if normal for the taxpayer. Section 711(b)(1)(J) permits the classification of other deductions in accordance with these regulations. In any case, the amount of deductions of any class which may be disallowed shall be determined in the manner previously set forth in this section.

Deductions attributable to any claim, award, judgment, or decree against the taxpayer, or interest on any of the foregoing are all of the same class. Therefore, in determining in the case of a deduction for a judgment, for example, whether the class of deductions is abnormal or whether the amount thereof for any taxable year is in excess of 125 per cent of average deductions of the same class, account must be taken not only of the amount of deductions for judgments, if any, allowed in preceding taxable years, but also of any deductions arising out of claims, awards, and decrees, and interest thereon.

Deductions for intangible drilling and development costs paid or incurred in or for the drilling of wells or the preparation of wells for the production of oil or gas, and for development costs in the case of mines are all of the same class. Therefore, for the purpose of determining whether the deductions for one taxable year are abnormal or in excess of 125 per cent of average deductions of this class, and for the purpose of determining the amount to be disallowed in such event, reference must be made to the deductions of the entire class, rather than to any particular deductible items included therein. Deductions attributable to the operation of wells or mines are not included in this class.

Deductions which do not fall within either of the classes specified in section 711(b)(1) (H) and (I) may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such other classes as are reasonable in a business of the type which the taxpayer conducts, and are appropriate in the light of the taxpayer's business experience and accounting practice. Such a classification will be applicable to all other taxable years considered at any time in adjusting deductions under this section, and must be consistent with any classification made by the taxpayer under the provisions of section 721 and section 722.

(*b*) *Statement required.*—If in computing its excess profits net income for a taxable year in the base period, the taxpayer claims the disallowance under section 711(b)(1) (H), (I), or (J) of any amount previously allowed as a deduction, there shall be submitted a full statement showing the computation of the amount to be disallowed, the prices and gross sales of the taxpayer's product, and the condition of the taxpayer's business which demonstrate that the disallowed amount is not a consequence of an increase in the gross income of the taxpayer in its base period or a decrease in the amount of some other deduction in its base period, and is not a consequence of a change at any time in the type, manner of operation, size, or condition of the business engaged in by the taxpayer. This statement shall be in duplicate and shall include the following: (1) the computation of the amount disallowed, showing the amount of the class of deductions in the base period taxable year for which any part of such amount is disallowed, the average amount of such class for the four preceding taxable years or for such taxable years as the taxpayer is required to use in determining this average amount, and the excess amount of deductions disallowed; (2) a description and the amount of each item included in such class of deductions for the taxable year for which such deductions are disallowed and for the taxable years in the test period, with the amount of each and a description thereof; (3) the amount of such class and the amount and description of each item in that class for the taxable year for which the excess profits tax is being computed; and (4) all other facts upon which the taxpayer relies.

PAR. 11. The following is inserted immediately preceding section 30.712–1:

SEC. 13. ALLOWANCE OF EXCESS PROFITS CREDIT. (Excess Profits Tax Amendments of 1941.)

Section 712 of the Internal Revenue Code is amended to read as follows:

"SEC. 712. EXCESS PROFITS CREDIT—ALLOWANCE.

"(a) DOMESTIC CORPORATIONS.—In the case of a domestic corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. In the case of all other domestic corporations the excess profits credit for any taxable year shall be an amount computed under section 714. (For allowance of excess profits credit in case of certain reorganizations of corporations, see section 741.)

"(b) FOREIGN CORPORATIONS.—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 first taxable year of which under this subchapter begins on any date in 1940, which was in existence on the day forty-eight months prior to such date and which at any time during each of the taxable years in such forty-eight months was engaged in trade or business within the United States or had an office or place of business therein, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. In the case of all other foreign corporations the excess profits credit for any taxable year shall be an amount computed under section 714.

"(c) EFFECT OF DISCLAIMER OF CREDIT.—If the taxpayer states in its return for the taxable year under this subchapter that it disclaims the use of the credit computed under section 713 or the use of the credit computed under section 714, the credit so disclaimed shall not, for the purposes of the internal revenue laws, be applicable to the computation of the tax under this subchapter for such taxable year."

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

PAR. 12. Section 30.712–1 is amended to read as follows:

SEC. 30.712–1. *Excess profits credit; allowance.*—Two methods are provided for computing the excess profits credit: (1) The income method under which the credit is computed as provided in section 713, and (2) the invested capital method under which the credit is computed as provided in section 714.

In the case of the following corporations, the excess profits credit for any taxable year shall be the credit based upon income, computed as provided in section 713, or the credit based on invested capital, computed as provided in section 714, whichever credit results in the lesser tax for the taxable year for which the tax is being computed:

(*a*) A domestic corporation which was actually in existence before January 1, 1940.

(*b*) A domestic corporation which is an "acquiring corporation" within the meaning of section 740 of Supplement A and which was constructively in existence at the beginning of its base period. (For computation of excess profits credit based on income in such cases, see sections 740 to 744.)

(*c*) A foreign corporation (1) which is engaged in trade or business within the United States, or has an office or place of business therein, at any time during the taxable year; (2) the first taxable year of which for the purposes of the excess profits tax begins on any day in 1940; (3) which was in existence on the date 48 months prior to such date; and (4) which, at any time during each of the taxable years in such 48 months, was engaged in trade or business within the United States, or had an office or place of business therein. As to what constitutes being engaged in trade or business within the United States, see section 19.231–1 of Regulations 103.

If a taxpayer disclaims in its return for a particular taxable year the use of either credit, the credit so disclaimed shall not, for the purposes of the internal revenue laws, be applicable to the computation of the tax for the taxable year with respect to which the disclaimer is made.

A domestic corporation which was not actually in existence before January 1, 1940, and which was not constructively in existence on the date of the beginning of its base period, and a foreign corporation which does not meet the requirements of (*c*) above, are required to compute their credit under the invested capital method provided in section 714.

PAR. 13. The following is inserted immediately preceding section 30.713–1:

SEC. 4. COMPUTATION OF AVERAGE BASE PERIOD NET INCOME. (Excess Profits Tax Amendments of 1941.)

(a) Section 713(a)(1) of the Internal Revenue Code is amended by striking out "subsection (b)" and inserting in lieu thereof "subsection (d)", and by striking out "subsection (c)" wherever occurring therein and inserting in lieu thereof "subsection (g)".

(b) Section 713(b) of the Internal Revenue Code is amended to read as follows:

"(b) BASE PERIOD.—

"(1) DEFINITION.—As used in this section the term 'base period'—

"(A) If the corporation was in existence during the whole of the forty-eight months preceding the beginning of its first taxable year under this subchapter, means the period commencing with the beginning of its first taxable year beginning after December 31, 1935, and ending with the close of its last taxable year beginning before January 1, 1940; and

"(B) In the case of a corporation which was in existence during only part of the forty-eight months preceding the beginning of its first taxable year under this subchapter, means the forty-eight months preceding the beginning of its first taxable year under this subchapter.

"(2) DIVISION INTO HALVES.—For the purposes of subsections (d) and (f) the base period of the taxpayer shall be divided into halves, the first half to be composed of one-half the entire number of months in the base period and to begin with the beginning of the base period.

"(c) DEFICIT IN EXCESS PROFITS NET INCOME.—For the purposes of this section the term 'deficit in excess profits net income' with respect to any taxable year means the amount by which the deductions plus the credit for dividends received exceeded the gross income. For the purposes of this subsection in determining whether there was such an excess and in determining the amount thereof, the adjustments provided in section 711(b)(1) shall be made.

"(d) AVERAGE BASE PERIOD NET INCOME—DETERMINATION.—

"(1) DEFINITION.—For the purposes of this section the average base period net income of the taxpayer shall be the amount determined under subsection (e), subject to the exception that if the aggregate excess profits net income for the last half of its base period, reduced by the aggregate of the deficits in excess profits net income for such half, is greater than such aggregate so reduced for the first half, then the average base period net income shall be the amount determined under subsection (f), if greater than the amount determined under subsection (e).

"(2) For the purposes of subsections (e) and (f), if the taxpayer was in existence during only part of the 48 months preceding the beginning of its first taxable year under this subchapter, its excess profits net income—

"(A) for each taxable year of twelve months (beginning with the beginning of its base period) during which it was not in existence, shall be an amount equal to 8 per centum of the excess of—

"(i) the daily invested capital for the first day of the taxpayer's first taxable year beginning after December 31, 1939, over

"(ii) an amount equal to the same percentage of such daily invested capital as is applicable under section 720 in reduction of the average invested capital of the preceding taxable year;

"(B) for the taxable year of less than twelve months consisting of that part of the remainder of its base period during which it was not in existence, shall be the amount ascertained for a full year under subparagraph (A), multplied by the number of days in such taxable year of less than twelve months and divided by the number of days in the twelve months ending with the close of such taxable year.

"(3) In no case shall the average base period net income be less than zero.

"(4) For the computation of average base period net income in the case of certain reorganizations, see section 742.

"(e) AVERAGE BASE PERIOD NET INCOME—GENERAL AVERAGE.—The average base period net income determined under this subsection shall be determined as follows:

"(1) By computing the aggregate of the excess profits net income for each of the taxable years of the taxpayer in the base period, reduced, if for more than one of such taxable years there was a deficit in excess profits net income, by the sum of such deficits, excluding the greatest;

"(2) By dividing the amount ascertained under paragraph (1) by the total number of months in all such taxable years; and

"(3) By multiplying the amount ascertained under paragraph (2) by twelve.

"(f) AVERAGE BASE PERIOD NET INCOME—INCREASED EARNINGS IN LAST HALF OF BASE PERIOD.—The average base period net income determined under this subsection shall be determined as follows:

"(1) By computing, for each of the taxable years of the taxpayer in its base period, the excess profits net income for such year, or the deficit in excess profits net income for such year;

"(2) By computing for each half of the base period the aggregate of the excess profits net income for each of the taxable years in such half, reduced, if for one or more of such years there was a deficit in excess profits net income, by the sum of such deficits. For the pur-

poses of such computation, if any taxable year is partly within each half of the base period there shall be allocated to the first half an amount of the excess profits net income or deficit in excess profits net income, as the case may be, for such taxable year, which bears the same ratio thereto as the number of months falling within such half bears to the entire number of months in such taxable year; and the remainder shall be allocated to the second half;

"(3) If the amount ascertained under paragraph (2) for the second half is greater than the amount ascertained for the first half, by dividing the difference by two;

"(4) By adding the amount ascertained under paragraph (3) to the amount ascertained under paragraph (2) for the second half of the base period;

"(5) By dividing the amount found under paragraph (4) by the number of months in the second half of the base period and by multiplying the result by twelve;

"(6) The amount ascertained under paragraph (5) shall be the average base period net income determined under this subsection, except that the average base period net income determined under this subsection shall in no case be greater than the highest excess profits net income for any taxable year in the base period. For the purpose of such limitation if any taxable year is of less than twelve months, the excess profits net income for such taxable year shall be placed on an annual basis by multiplying by twelve and dividing by the number of months included in such taxable year.

"(7) For the purposes of this subsection, the excess profits net income for any taxable year ending after May 31, 1940, shall not be greater than an amount computed as follows:

"(A) By reducing the excess profits net income by an amount which bears the same ratio thereto as the number of months after May 31, 1940, bears to the total number of months in such taxable year; and

"(B) By adding to the amount ascertained under subparagraph (A) an amount which bears the same ratio to the excess profits net income for the last preceding taxable year as such number of months after May 31, 1940, bears to the number of months in such preceding year. The amount added under this subparagraph shall not exceed the amount of the excess profits net income for such last preceding taxable year.

"(C) If the number of months in such preceding taxable year is less than such number of months after May 31, 1940, by adding to the amount ascertained under subparagraph (B) an amount which bears the same ratio to the excess profits net income for the second preceding taxable year as the excess of such number of months after May 31, 1940, over the number of months in such preceding taxable year bears to the number of months in such second preceding taxable year."

(c) Section 713(c) of the Internal Revenue Code is amended by striking out "(c)" and inserting in lieu thereof "(g)".

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SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

PAR. 14. Section 30.713–1 is amended as follows:

(A) By inserting immediately after the heading a new subsection (*a*) to read as follows:

(*a*) *Introductory.*—In order for a corporation to determine for any particular taxable year the amount of its excess profits credit based on income, it is necessary first to compute the amount of the average base period net income, 95 per cent of which is the starting point for computing the excess profits credit based on income. Two methods are provided for determining the average base period net income: (1) The general average method, set forth in section 713(e) and in subsection (*b*) of this section, and (2) the method set forth in section 713(f) and in subsection (c) of this section, applicable to cases in which the

earnings for the last half of the base period are greater than those for the first half, if such method results in a greater average base period net income than that resulting from the use of the general average method.

(B) By striking out the heading, the first sentence, and the portion of the second sentence preceding the colon, of old subsection (*a*) and inserting in lieu thereof the following:

(*b*) *Computation under the general average method.*—The following steps are required for the computation of the average base period net income under the general average method (for computation of excess profits net income for portions of its base period during which the corporation was not in existence, see subsection (*d*) of this section):

(C) By inserting a new subsection (*c*) immediately after new subsection (*b*) to read as follows:

(*c*) *Computation under section 713(f); increased earnings in last half of base period.*—The determination of the base period net income under the method set forth in section 713(f) is operative only if the aggregate excess profits net income for the last half of the base period of the taxpayer, reduced by the aggregate of the deficits in excess profits net income for such half, is greater than such aggregate so reduced for the first half and the average base period net income determined under section 713(f) is greater than the amount determined under section 713(e). The following steps are required for the computation of the average base period net income under the method set forth in section 713(f):

(1) The excess profits net income or the deficit in excess profits net income for each of the taxable years in the base period (years beginning after December 31, 1935, and before January 1, 1940) is to be determined as provided in section 711(b).

(2) The base period is to be divided into halves, each of an equal number of months. There is to be computed for each half of the base period the aggregate of the excess profits net income for each of the taxable years in such half, reduced, if for one or more of such years there was a deficit in excess profits net income, by the sum of such deficits. In making this computation, a deficit in excess profits net income for any taxable year (or in the case of more than one deficit, the greatest deficit) is not counted as zero as in the case of the computation under the general average method described in subsection (*b*) of this section.

(3) The excess of the amount ascertained for the second half over the amount ascertained for the first half is to be divided by 2.

(4) The amount ascertained under paragraph (3) is to be added to the amount ascertained under paragraph (2) for the second half of the base period.

(5) The amount found under paragraph (4) is to be divided by the number of months in the second half of the base period and the result multiplied by 12.

(6) The amount ascertained under paragraph (5) shall be the average base period net income determined under the method set forth in section 713(f), except that the average base period net income so determined shall in no case be greater than the highest excess profits net income for any taxable year in the base period. For the purpose of this limitation if any taxable year is less than 12 months, the excess profits net income for such taxable year shall be placed on an annual basis by multiplying by 12 and dividing by the number of months included in such taxable year.

The computation of the average base period net income under the method set forth in section 713(f) may be illustrated by the following example:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has the following amounts of excess profits net income for the taxable years in its base period: 1936, $100,000; 1937, $200,000; 1938, $300,000; and 1939, $400,000. Its average base period net income under the method set forth in section 713(f) is $400,000, computed as follows:

(1) Aggregate of excess profits net income for taxable years in second half of base period ($300,000 plus $400,000)	$700,000
(2) Aggregate of excess profits net income for taxable years in first half of base period ($100,000 plus $200,000)	300,000
(3) Item (1) less item (2) ($700,000 minus $300,000)	400,000

(4) Item (3) divided by 2 ($400,000 divided by 2)	$200,000
(5) Sum of item (1) plus item (4) ($700,000 plus $200,000)	900,000
(6) Item (5) placed on annual basis by dividing it by number of months in second half of base period and multiplying by 12 (($900,000 divided by 24) multiplied by 12)	450,000
(7) Highest excess profits net income for any taxable year in base period (1939)	400,000
(8) Average base period net income (item (7) since such item is less than item (6))	400,000

The provision of section 713(f)(2) relative to the manner of computation of the aggregate excess profits net income for each half of the base period where the taxpayer, because of changes in its accounting period or for other reasons, has more or less than four taxable years in such period, and where part of one taxable year is in the first half and the other part is in the second half of such period, may be illustrated by the following example:

Example. A corporation has taxable years in its base period and excess profits net incomes for such years as follows:

Years in base period.		Number of months.	Excess profits net income.
Beginning—	Ending—		
Sept. 1, 1936	Aug. 31, 1937	12	$30,000
Sept. 1, 1937	Dec. 31, 1937	4	20,000
Jan. 1, 1938	Dec. 31, 1938	12	60,000
Jan. 1, 1939	Dec. 31, 1939	12	100,000
Total		40	210,000

The aggregate excess profits net income for the first half of the base period is $70,000, and for the second half it is $140,000, computed as follows:

	Number of months.	Excess profits net income.
FIRST HALF.		
The taxable year beginning Sept. 1, 1936, and ending Aug. 31, 1937	12	$30,000
The taxable year beginning Sept. 1, 1937, and ending Dec. 31, 1937	4	20,000
One-third of the taxable year beginning Jan. 1, 1938, and ending Dec. 31, 1938	4	20,000
Total	20	70,000
SECOND HALF.		
Two-thirds of the taxable year beginning Jan. 1, 1938, and ending Dec. 31, 1938	8	40,000
The taxable year beginning Jan. 1, 1939, and ending Dec. 31, 1939	12	100,000
Total	20	140,000

For the purpose of computing the average base period net income thereunder, section 713(f)(7) provides certain limitations on the amount of the excess profits net income for any taxable year in the base period ending after May 31, 1940.

Section 713(f)(7) (A) and (B) may be illustrated by the following example:

Example. The Y Corporation makes its income tax returns on the basis of the fiscal year ending September 30. It had an excess profits net income of $400,000 for the fiscal year ended September 30, 1939. It had an excess profits net income of $600,000 for the fiscal year ended September 30, 1940, before the application of section 713(f)(7) (A) and (B). Both of these taxable years are in its base period but four months of the fiscal year ended September 30, 1940, are after May 31, 1940. Under section 713(f)(7) (A) and (B) the excess profits net income of the corporation for the fiscal year beginning

October 1, 1939, and ended September 30, 1940, is $533,333.33, computed as follows:

(1) Excess profits net income before application of section 713(f)(7) (A) and (B)	$600,000.00
(2) Amount by which item (1) is to be reduced under section 713(f)(7)(A) (four-twelfths of $600,000)	200,000.00
(3) Item (1) less item (2) ($600,000 minus $200,000)	400,000.00
(4) Amount to be added to item (3) under section 713(f)(7)(B) (four-twelfths of $400,000)	133,333.33
(5) Excess profits net income for fiscal year ended September 30, 1940, after application of section 713(f)(7) (item (3) plus item (4), or $400,000 plus $133,333.33)	533,333.33

Section 713(f)(7)(C) may be illustrated by the following example:

Example. The last three taxable years in the base period of the Z Corporation and the number of months in, and the excess profits net income for, such taxable years are as follows:

Taxable years.		Number of months.	Excess profits net income.
Beginning—	Ending—		
July 1, 1938	June 30, 1939	12	$400,000
July 1, 1939	Sept. 30, 1939	3	75,000
Oct. 1, 1939	Sept. 30, 1940	12	600,000

Under section 713(f)(7) the excess profits net income of the corporation for the fiscal year ended September 30, 1940, is $508,333.33, computed as follows:

(1) Excess profits net income before application of section 713(f)(7) (A) and (B)	$600,000.00
(2) Amount by which item (1) is to be reduced under section 713(f)(7)(A) (four-twelfths of $600,000)	200,000.00
(3) Item (1) less item (2) ($600,000 minus $200,000)	400,000.00
(4) Amount to be added to item (3) under section 713(f)(7)(B) (four thirds of $75,000 but not in excess of $75,000)	75,000.00
(5) Amount to be added to item (3) under section 713(f)(7)(C) (one-twelfth of $400,000)	33,333.33
(6) Excess profits net income for fiscal year ended September 30, 1940, after application of section 713(f)(7) (sum of items (3), (4), and (5), or $400,000 plus $75,000 plus $33,333.33)	508,333.33

(D) By changing old subsection (*b*) as follows:

(*a*) By changing the designation to (*d*).

(*b*) By changing the heading to read as follows: "*Computation of excess profits net income for portions of base period during which corporation was not in existence; applicable both under sections 713(e) and 713(f).*"

(*c*) By striking out in the second sentence "Section 713(b)(5)" and inserting in lieu thereof "Section 713(d)(2)."

(*d*) By changing the example to read as follows:

Example. The Z Corporation, a domestic corporation which makes its income tax returns on the calendar year basis, was organized on July 1, 1937. The daily invested capital of the corporation for January 1, 1940, is $200,000. The percentage of such invested capital which would be applicable under section 720 in reduction of the average invested capital of the corporation on account of inadmissible assets for the calendar year 1939 is 5.

The excess profits net income of the Z Corporation for 1936 is $15,200, and for the period January 1, 1937, to June 30, 1937, $7,537.53, computed as follows:

(1) Daily invested capital for January 1, 1940	$200,000.00
(2) Amount equal to the same percentage (5 per cent) of item (1) as is applicable under section 720 in reduction of the average invested capital for preceding taxable year, 1939 ($200,000 multiplied by 0.05)	10,000.00
(3) Excess of item (1) over item (2)	190,000.00
(4) Excess profits net income for 1936 ($190,000 multiplied by 0.08)	15,200.00
(5) Excess profits net income for period from January 1, 1937, to June 30, 1937 $\left(\frac{\$15,200 \times 181}{365}\right)$	7,537.53

PAR. 15. Section 30.714–1 is amended by striking out the first sentence and inserting in lieu thereof the following:

Section 714 applies only to a corporation which under section 712 is entitled or is required to compute its excess profits credit under the invested capital method.

PAR. 16. The following is inserted immediately preceding section 30.720–1:

SEC. 12. ADMISSIBLE ASSETS OF DEALERS IN SECURITIES. (Excess Profits Tax Amendments of 1941.)

(a) Section 720(a)(1)(A) of the Internal Revenue Code is amended to read as follows:

"(A) Stock in corporations except stock in a foreign personal-holding company, and except stock which is not a capital asset; and"

* * * * *

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

PAR. 17. Section 30.720–1 is amended as follows:

(A) The second sentence of the first paragraph is amended to read as follows:

The term "inadmissible assets" means (1) stock in all corporations, domestic or foreign, except stock in a foreign personal-holding company, and except stock which is not a capital asset (such as stock held primarily for sale to customers by a dealer in securities), and (2) all obligations described in section 22(b)(4), any part of the interest from which is excludible from gross income or allowable as a credit against net income.

(B) The first sentence of the example is amended to read as follows:

The average invested capital of the X Corporation, not a dealer in securities, for its taxable year 1940, determined under section 716, is $1,000,000.

PAR. 18. Section 30.721–1 is stricken out, and there is inserted in lieu thereof the following:

SEC. 5. ABNORMALITIES IN INCOME IN TAXABLE PERIOD. (Excess Profits Tax Amendments of 1941.)

Section 721 of the Internal Revenue Code is amended to read as follows:

"SEC. 721. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

"(a) DEFINITIONS.—For the purposes of this section—

"(1) ABNORMAL INCOME.—The term 'abnormal income' means income of any class includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 125 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

"(2) SEPARATE CLASSES OF INCOME.—Each of the following subparagraphs shall be held to describe a separate class of income:

"(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

"(B) Income constituting an amount payable under a contract the performance of which required more than 12 months; or

"(C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; or

"(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's accounting period or method of accounting; or

"(E) In the case of a lessor of real property, income included in gross income for the taxable year by reason of the termination of the lease; or

"(F) Income consisting of dividends on stock of foreign corporations, except foreign personal holding companies.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (F), inclusive, shall be subject to regulations prescribed by the Commissioner with the approval of the Secretary.

"(3) NET ABNORMAL INCOME.—The term 'net abnormal income' means the amount of the abnormal income less, under regulations prescribed by the Commissioner with the approval of the Secretary, (A) 125 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any direct costs or expenses, deductible in determining the normal-tax net income of the taxable year, through the expenditure of which such abnormal income was in whole or in part derived as the excess of the amount of such abnormal income over 125 per centum of such average amount bears to the amount of such abnormal income.

"(b) AMOUNT ATTRIBUTABLE TO OTHER YEARS.—The amount of the net abnormal income that is attributable to any previous or future taxable year or years shall be determined under regulations prescribed by the Commissioner with the approval of the Secretary. In the case of amounts otherwise attributable to future taxable years, if the taxpayer either transfers substantially all its properties or distributes any property in complete liquidation, then there shall be attributable to the first taxable year in which such transfer or distribution occurs (or if such year is previous to the taxable year in which the abnormal income is includible in gross income, to such latter taxable year) all amounts so attributable to future taxable years not included in the gross income of a previous taxable year.

"(c) COMPUTATION OF TAX FOR CURRENT TAXABLE YEAR.—The tax under this subchapter for the taxable year, in which the whole of such abnormal income would without regard to this section be includible, shall not exceed the sum of:

"(1) The tax under this subchapter for such taxable year computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable year, and

"(2) The aggregate of the increase in the tax under this subchapter which would have resulted for each previous taxable year to which any portion of such net abnormal income is attributable, computed as if an amount equal to such portion had been included in the gross income for such previous taxable year.

"(d) COMPUTATION OF TAX FOR FUTURE TAXABLE YEAR.—The amount of the net abnormal income attributable to any future taxable year shall, for the purposes of this subchapter, be included in the gross

income for such taxable year. The tax under this subchapter for such future taxable year shall not exceed the sum of—

"(1) the tax under this subchapter for such future taxable year computed without the inclusion in excess profits net income of the portion of such net abnormal income which is attributable to such year, and

"(2) the decrease in the tax under this subchapter for the previous taxable year in which the whole of such abnormal income would without regard to this section be includible, which resulted by reason of the exclusion of the whole or a part of the abnormal income from the gross income for such previous taxable year; but the amount of such decrease shall be diminished by the aggregate of the increases in the tax under this subchapter which have resulted for the taxable years intervening between such previous taxable year and such future taxable year because of the inclusion in the gross income of the portions of such net abnormal income attributable to such intervening years."

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

SEC. 30.721–1. *Abnormalities in income in taxable year.*—Section 721 provides relief where abnormal income (as defined in section 721(a)) for any excess profits tax taxable year is attributable to other taxable years. The term "abnormal income" means income of any class includible in the gross income of the taxpayer for any excess profits tax taxable year (A) if it is abnormal for the taxpayer to derive gross income of such class, or (B) if the taxpayer normally derives gross income of such class but the amount of such income of such class is in excess of 125 per cent of the average amount of the gross income of the same class determined for the four previous taxable years or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence. It is abnormal for a taxpayer to derive income of any class only if the taxpayer had no gross income of that class for the four previous taxable years. For the purpose of determining abnormal income under this paragraph the gross income of the class for the previous taxable years is not to be increased or decreased by any allocation under the provisions of section 721. Abnormal income is to be determined by considering classes of income, and not merely particular items. As to the classification of income, see section 30.721–2.

Abnormal income must be adjusted, as provided in section 721(a)(3), in order to determine net abnormal income. Net abnormal income must then be allocated to the various items included in abnormal income. The items of net abnormal income so determined are the amounts which may be attributed to other taxable years under these regulations. Net abnormal income and the allocated amounts which are items of net abnormal income are determined in the following manner:

(*a*) Net abnormal income is determined as follows:

(1) The abnormal income of each class is computed;

(2) Such abnormal income is then reduced by 125 per cent of the average amount of the gross income of the same class for the four previous taxable years or, if the taxpayer was not in existence for four previous taxable years, the previous taxable years during which it was in existence;

(3) The abnormal income is further reduced by an amount which bears the same ratio to the amount of any direct costs or expenses, deductible in determining the normal-tax net income for the taxable year, through the expenditure of which such abnormal income was in whole or in part derived, as the abnormal income, reduced as provided in (a)(2), bears to the abnormal income. The amount thus determined is the net abnormal income.

(*b*) The items of net abnormal income are determined as follows:

(1) Each item of abnormal income is reduced, but not below zero, by an amount equal to 125 per cent of the average income, if any, for the four previous taxable years, arising out of the same property as the income represented by the item;

(2) Each item of abnormal income is further reduced, but not below zero, by an amount which bears the same ratio to the amount of any direct costs or expenses, deductible in determining the normal-tax net income for

the taxable year, through the expenditure of which such item was in whole or in part derived, as the amount of the item of abnormal income reduced in (b)(1) bears to the amount of the item of abnormal income;

(3) The aggregate of the items as reduced under (b) (1) and (2) is determined;

(4) Net abnormal income is allocated to each item in the proportion that the item, reduced as provided in (b) (1) and (2), bears to the aggregate of the items so reduced, determined in (b)(3). The amount so allocated is an item of net abnormal income.

The following examples illustrate the computation of items of net abnormal income:

Example (1). For the taxable year 1941, the A Corporation, which makes its income tax returns on the calendar year basis, has gross income of $1,000,000 from judgments. This consists of two items, one of $800,000 for a judgment against X and the other of $200,000 for a judgment against Y. Its average income of this class for the four previous taxable years was $300,000. For 1941, it has direct deductible expenses of $160,000 applicable to the judgment against X. There were no direct deductible expenses applicable to the other judgment. The $1,000,000 is abnormal income, since it is in excess of 125 per cent of the average income of this class for the four previous taxable years. The items of net abnormal income represented by the judgments are determined as follows:

(1) Abnormal income		$1,000,000
(2) Less 125 per cent of average income ($300,000) for the four previous taxable years		375,000
(3) Excess of (1) over (2)		625,000
(4) Less an amount bearing same ratio to $160,000 (deductions applicable to items in this class) as $625,000 bears to $1,000,000		100,000
(5) Net abnormal income		525,000
(6) Gross income on account of the judgment against X	$800,000	
(7) Less deductions applicable to such item	160,000	
(8) Amount of (6) reduced by (7)		640,000
(9) Gross income on account of the judgment against Y	$200,000	
(10) Less deductions applicable to such item	None	
(11) Amount of (9) reduced by (10)		200,000
(12) Aggregate of (8) and (11)		840,000
(13) Portion of net abnormal income allocated to the judgment against X (640,000/840,000 of $525,000)		400,000
(14) Portion of net abnormal income allocated to the judgment against Y (200,000/840,000 of $525,000)		125,000

Example (2). For the taxable year 1941, the A Corporation has $134,062.50 net abnormal income from the two oil leases which it developed. One lease, on the X field, produced an average of $60,000 a year during the four previous taxable years, and $85,000 in 1941. There were $6,800 direct expense applicable to this lease. The other lease, on the Y field, produced no income in the four previous years. In 1941, there were $38,200 direct expenses applicable to this lease. The lease produced $155,000 income in 1941. The item of net abnormal income represented by the X lease is $9,788.69, and the item represented by the Y lease is $124,273.81, computed as follows:

(1) Gross income on account of the X lease	$85,000.00
(2) Less 125 per cent of average income of this lease for the four previous taxable years (125 per cent of $60,000)	75,000.00
(3) Item (1) less item (2)	10,000.00
(4) Less amount bearing same ratio to $6,800 (expenses applicable to this lease) as $10,000 bears to $85,000	800.00

(5) Income from X lease reduced on account of average income and applicable expenses		$9,200.00
(6) Gross income on account of Y lease	$155,000.00	
(7) Less 125 per cent of average income for the four previous taxable years	None	
(8) Item (6) less item (7)	155,000.00	
(9) Less amount bearing same ratio to $38,200 (expenses applicable to this lease) as $155,000 bears to $155,000	38,200.00	
(10) Income from Y lease reduced on account of average income and applicable expenses		116,800.00
(11) Aggregate of item (5) and item (10)		126,000.00
(12) Portion of net abnormal income allocated to the X lease (9,200/126,000 of $134,062.50)		9,788.69
(13) Portion of net abnormal income allocated to the Y lease (116,800/126,000 of $134,062.50)		124,273.81

SEC. 30.721–2. *Classification of income.*—Section 721(a)(2)(A), (B), (C), (D), (E), and (F) sets forth six separate classes of income. Income which does not fall within those provisions may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such other classes as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice.

All the income which reasonably is classifiable in more than one class shall be classified under the one which the taxpayer irrevocably elects. Such election shall be made in the manner prescribed in section 30.721–3.

The classification of income in any year must be consistent with the classification made under section 721 for previous years. The classification must also be consistent with any classification made in applying to the taxpayer section 722 or section 711(b)(2)(H), (I), or (J).

SEC. 30.721–3. *Amount attributable to other years.*—The mere fact that an item includible in gross income is of a class abnormal either in kind or in amount does not result in the exclusion of any part of such item from excess profits net income. It is necessary that the item be found attributable under these regulations in whole or in part to other taxable years. Only that portion of the item which is found to be attributable to other years may be excluded from the gross income of the taxpayer for the year for which the excess profits tax is being computed.

Items of net abnormal income are to be attributed to other years in the light of the events in which such items had their origin, and only in such amounts as are reasonable in the light of such events. To the extent that any items of net abnormal income in the taxable year are the result of high prices, low operating costs, or increased physical volume of sales due to increased demand for or decreased competition in the type of product sold by the taxpayer, such items shall not be attributed to other taxable years. Thus, no portion of an item is to be attributed to other years if such item is of a class of income which is in excess of 125 per cent of the average income of the same class for the four previous taxable years solely because of an improvement in business conditions. In attributing items of net abnormal income to other years, particular attention must be paid to changes in those years in the factors which determined the amount of such income, such as changes in prices, amount of production, and demand for the product. No portion of an item of net abnormal income is to be attributed to any previous year solely by reason of an investment by the taxpayer in assets, tangible or intangible, employed in or contributing to the production of such income.

Section 721 has no effect upon the computation of base period net income or of earnings and profits and therefore does not affect the computation of the excess profits credit. Similarly, it has no application in the determination of taxes other than the excess profits tax imposed by Subchapter E of Chapter 2. Amounts attributed to future years are to be included in gross income for such years for excess profits tax purposes only. If the taxpayer either transfers substantially all its properties or distributes any property in complete liquidation prior to the close of the last future year to which any such amounts are attributable, then all amounts of net abnormal income attributable to years subsequent to both—

(*a*) the first year in which such transfer or distribution in liquidation occurs, and

(*b*) the taxable year in the gross income of which such abnormal income would have been included except for section 721

shall be included in the gross income for the year referred to in (*a*) or the year referred to in (*b*), whichever is the later. For example, if a taxpayer realizes in 1944 net abnormal income attributable to the years 1942 to 1946, inclusive, and in 1945 begins to distribute its property in complete liquidation, the portion of the net abnormal income attributable to the future year 1946 is to be reallocated to and included in the gross income for 1945 (the first year of liquidation) in addition to the amount already attributed to that year. If the first distribution in liquidation occurred before the year of realization, for example, in 1943, the portions of the net abnormal income attributable to the future years 1945 and 1946 would be included in the gross income for 1944 (the year of realization) in addition to the amount already attributed to that year. In neither event will the allocations originally made to 1942, 1943, and 1944 be disturbed.

Specific methods of treating items of net abnormal income of the six classes specified in section 721(a) are set forth in sections 30.721–6 to 30.721–11. These methods are to be applied subject to the provisions of this section.

A taxpayer claiming the benefits of section 721 shall file with its excess profits tax return a detailed statement in duplicate containing the following information:

(1) the amount and a description of each class of income claimed to be abnormal, and the amount and a description of each item in each such class;

(2) for each class of income claimed to be abnormal, the amount and a description of each item of income of the same class derived during the four taxable years immediately preceding the taxable year, and the aggregate amount of such items for each taxable year;

(3) for each class of income claimed to be abnormal, the amount of net abnormal income, the amount of each item of net abnormal income, and the computations by which these amounts were determined;

(4) the transactions in which each such item had its origin, the method used in allocating such item, the amount allocated to each year, and the reasons therefor; and

(5) all other facts upon which the taxpayer relies.

If any item of income is reasonably classifiable in more than one class, the inclusion of such item in any one of such classes in the statement referred to above shall constitute an irrevocable election by the taxpayer for the purpose of section 721(a)(2).

SEC. 30.721–4. *Computation of tax for current taxable year.*—The excess profits tax for the taxable year shall be the smaller of the following amounts:

(*a*) The excess profits tax computed without excluding from gross income any amounts attributable to other years under section 721; or

(*b*) The sum of (1) the excess profits tax for the taxable year computed without including in gross income the amount of items of net abnormal income attributable to other taxable years, and (2) the aggregate of the amounts of additional excess profits tax which would have resulted for previous excess profits tax taxable years if the gross income for each such taxable year had been increased by the inclusion therein of the amount of items of net abnormal income attributable thereto.

For an illustration of the computations required by this section, see the example in section 30.721–6.

SEC. 30.721–5. *Computations of tax for future taxable years.*—Amounts of items of net abnormal income attributable to a future taxable year shall be included in the gross income of such taxable year for the purposes of the excess profits tax. The excess profits tax for a future taxable year to which any portion of the net abnormal income for a previous taxable year is attributed is the smaller of the amounts determined under (*a*) and (*b*) below:

(*a*) The excess profits tax for such year computed with the inclusion in gross income of such portion of the net abnormal income;

(*b*) The sum of—

(1) the excess profits tax for such year computed without the inclusion in gross income of such portion of the net abnormal income, and

(2) the excess of—

(i) the decrease in excess profits tax for the year of realization which resulted from the exclusion of the net abnormal income from the gross income for such year, over

(ii) the aggregate of the increases in excess profits tax for intervening years resulting from the inclusion in gross income of other portions of such net abnormal income.

This section may be illustrated by the following example:

Example. In the taxable year 1940, the A Corporation realized $18,000 net abnormal income, $2,000 of which is attributed to the taxable year 1940 and $4,000 to each of the taxable years 1941 through 1944. For the years 1940 through 1942, the adjusted excess profits net income, computed with these attributed amounts included in gross income, and the resulting excess profits tax are as follows:

	Adjusted excess profits income.	Excess profits tax.
1940	$4,000	$1,000
1941	54,000	15,400
1942	104,000	33,100

The adjusted excess profits net income for 1943, after the inclusion in gross income of the amount attributed to such year, is $124,000. The excess profits tax for such year is $40,500, computed as follows:

(*a*)	Tax on $124,000, computed without regard to the limitations of section 721(d)		$41,100
(*b*)	(1) Tax on $120,000 (income for 1943 excluding amount attributed to such year)		39,500
	(2) (A) Tax for 1940 if section 721 were not applied to the net abnormal income for such year (tax on $4,000 plus the $16,000 attributed to other years, or a total of $20,000)	$5,000	
	(B) Less tax for 1940 after application of section 721	1,000	
	(C) Decrease in tax for 1940 due to application of section 721		4,000
	(3) (A) Tax for 1941 after application of section 721	$15,400	
	(B) Less tax for 1941 if attributed income of $4,000 were excluded from gross income (tax on $50,000)	14,000	
	(C) Increase in tax for 1941 due to inclusion of attributed income	1,400	
	(4) (A) Tax for 1942 after application of section 721	$33,100	
	(B) Less tax for 1942 if attributed income of $4,000 were excluded from gross income (tax on $100,000)	31,500	
	(C) Increase in 1942 tax due to inclusion of attributed income	1,600	
	(5) Aggregate of increases in tax for intervening years 1941 and 1942 (item (3) (C) plus item (4)(C))		3,000
	(6) Excess of decrease in tax for 1940 over aggregate of increases in tax for intervening years 1941 and 1942 (item (2)(C) minus item (5))		1,000
	(7) Sum of tax on income for 1943, excluding amount attributed to such year, plus excess of decrease in tax for 1940 over aggregate of increases in tax for 1941 and 1942 (item (1) plus item (6))		40,500

Since the amount computed in (*b*)(7), $40,500, is less than the amount computed in (*a*), $41,100, the excess profits tax of the A Corporation for 1943 is $40,500, the smaller amount.

In the above example, the decrease in tax for 1940 ($4,000) has been equaled by the aggregate of the increases in tax for the intervening years 1941 through 1943 ($1,400+$1,600+$1,000). Therefore, the $4,000 attributed to 1944 has no effect on the tax for that year.

PAR. 19. Section 30.721–2 is renumbered section 30.721–6 and is further amended as follows:

(A) The first two sentences are amended to read as follows:

The first class of potentially abnormal income specifically set forth in section 721(a)(2) is income arising out of a claim, award, judgment, or decree, or interest thereon. All items of such income are of the same class.

(B) The first paragraph of the example is amended by changing the heading of the last column of the tabulation from "Gross income" to "Income attributed," and by substituting for the second sentence thereof the following two sentences:

The X Corporation has not in any prior year derived income from any like source; nor are there any direct expenses involved in obtaining the judgment which are deductible for 1941. This amount, therefore, represents the net abnormal income, and is the only item included therein.

PAR. 20. Section 30.721–3 is renumbered section 30.721–7, and is further amended as follows:

(A) The first sentence is amended to read as follows:

The second class of potentially abnormal income specifically set forth in section 721(a)(2) is income constituting amounts payable under contracts the performance of which required more than 12 months.

(B) The example in such section is amended to read as follows:

Example. In 1941 the A Corporation which makes its income tax returns on the calendar year basis completes two contracts for the construction of buildings, one of which was begun in 1938 and the other in 1939. Its gross income for 1941 from the two long-term contracts amounts to $1,000,000, of which $800,000 is derived from the 1938 contract and $200,000 from the 1939 contract. It reports income of this class upon the completed contract basis in accordance with section 19.42–4(*b*), Regulations 103, and corresponding provisions of prior regulations. Its gross income from long-term contracts for the years 1937, 1938, 1939, and 1940 amounted to $250,000, $350,000, $200,000, and $400,000, respectively. Therefore, in 1941 the gross income ($1,000,000) arising from long-term contracts is in excess of 125 per cent ($375,000) of the average gross income ($300,000) of that class for the years 1937, 1938, 1939, and 1940. Such gross income for 1941 is therefore subject to the treatment provided in section 721. If there were no direct expenses other than those already taken into account in determining gross income, the net abnormal income of this class is $1,000,000 minus $375,000, or $625,000. The item of net abnormal income for the 1938 contract is $500,000 ($800,000/1,000,000 of $625,000). See section 30.721–3. Similarly the item of net abnormal income for the 1939 contract is $125,000 (200,000/1,000,000 of $625,000). Assuming that the total expenditures properly applicable to the 1938 contract amount to $5,000,000, of which the respective sums of $500,000, $1,250,000, $1,500,000, and $1,750,000 are allocable to the years 1938, 1939, 1940, and 1941, then the item of $500,000 derived from the 1938 contract is attributable to those years in the respective amounts of $50,000, $125,000, $150,000, and $175,000. In like manner the amount of $125,000 representing the gross income derived from the 1939 contract shall be attributed to the years 1939, 1940, and 1941 in proportion to the expenditures applicable to that contract. For method of computation of the excess profits tax for the year 1941, see section 30.721–4 and the example in section 30.721–6.

PAR. 21. Section 30.721–4 is renumbered section 30.721–8, and is amended to read as follows:

SEC. 30.721–8. *Exploration, discovery, prospecting, research, or development.*—The third class of potentially abnormal income specifically set forth in section

721(a)(2) is income resulting from exploration, discovery, prospecting, research, or development of tangible property (such as mines, oil producing property, and timber tracts), patents, formulae, or processes, or any combination thereof, extending over a period of more than 12 months. The exploration, discovery, prospecting, research, or development must be that of the taxpayer. Income resulting from activities of such a character carried on by a predecessor is not entitled to the treatment provided in section 721.

An item of income resulting from exploration, discovery, prospecting, research, or development is all such income for the taxable year arising out of a unit of property such as an oil lease or other mineral property defined in section 19.23(m)-1(*i*), a patent, or a formula. If the taxpayer engages in manufacturing, marketing, mining, oil production, or similar activities, only such portion of the resulting income as is attributable to exploration, discovery, prospecting, research, or development is within the class of income described in this section. For example, the A Corporation develops a patented device and itself manufactures and sells such device. It also permits other corporations to manufacture such device upon payment of a royalty of $10 for each device produced. Income resulting from the development of the device is the sum of the royalties included in income and so much of the income arising out of the sale of the units manufactured by the taxpayer itself as does not exceed $10 for each device so manufactured and sold.

In general, an item of net abnormal income of the class described in this section is to be attributed to the taxable years during which expenditures were made for the particular exploration, discovery, prospecting, research, or development which resulted in such item being realized and in the proportion which the amount of such expenditures made during each such year bears to the total of such expenditures. Allocation of items of net abnormal income of the class described in this section must be made according to the principles set forth in section 30.721–3.

This section may be further illustrated by the following examples:

Example (1). In January, 1938, the X Corporation began the development of a certain device on which it expended considerable sums. The corporation secures a patent on such device in December, 1940, and in the same month sells such patent at a profit. It did not in any of the four immediately preceding years derive income of the class specified in section 721(a)(2)(C). The net abnormal income represented by this item is $250,000. In 1938, the corporation expended $50,000 on the development of this device, $100,000 in 1939, and $150,000 in 1940, a total of $300,000. For excess profits tax purposes, one-sixth (50,000/300,000) of the item of $250,000 is, therefore, attributable to 1938; one-third (100,000/300,000) is attributable to 1939; and one-half (150,000/300,000) is attributable to 1940. For method of computation of the excess profits tax for the year 1940, see section 30.721–4 and the example in section 30.721–5.

Example (2). In 1939, the A Corporation purchased from X, an inventor, the rights to a device he was developing, paying him $4,500 for such rights. In perfecting the device, the corporation spent $3,000 in 1939 and $6,000 in 1940, or a total of $9,000. A patent was obtained on the device in 1940, and it was licensed for use in the industry. The corporation had a $15,000 item of net abnormal income in 1940 as a result of the royalties received for the use of this device. Of this item, $5,000 ($\frac{3000}{9000}$ of $15,000) is attributable to 1939, and may be excluded from gross income for the year 1940 in the computation of excess profits tax for that year. For method of computation of the excess profits tax for the year 1940, see section 30.721–4 and the example in section 30.721–6.

PAR. 22. Section 30.721–5 is renumbered section 30.721–9, and is further amended as follows:

(A) The first paragraph is amended to read as follows:

The fourth class of potentially abnormal income specifically set forth in section 721(a)(2) is income which is includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's accounting period or method of accounting. This class may include such items of income as are includible in gross income for the taxable year by reason of a change from the installment method to the straight accrual method of accounting, a change in inventory method, or a change from the reserve method to the specific charge-off method for the treatment of bad debts. Items of net abnormal income includible in gross income for the taxable year rather than for a different taxable year by reason of a change from the installment method to the straight accrual

method of accounting shall be attributed to the year or years such items accrued. The method of allocating items of net abnormal income includible in gross income for the taxable year rather than for a different year by reason of other changes in accounting method or changes in accounting period is to be determined in each particular case upon consideration of all the facts in the case. (See section 30.721–3 as to the statement required to be filed where the benefits of section 721 are claimed.)

(B) The last paragraph is amended to read as follows:

Under the provisions of section 30.721–3, the items of net abnormal income included in the abnormal income of $380,000 resulting from sales contracts made prior to 1940 are to be attributed to the years in which such contracts were made. For method of computation of the excess profits tax for the year 1940, see section 30.721–4 and the example in section 30.721–6.

PAR. 23. Section 30.721–6 is renumbered section 30.721–10, and is amended to read as follows:

SEC. 30.721–10. *Income derived by lessor from termination of lease.*—The fifth class of potentially abnormal income specifically set forth in section 721(a)(2) is amounts included in the gross income of a lessor for the taxable year by reason of the termination of the lease. Amounts may be required to be so included by reason of the fact that improvements made by the lessee upon the leased property come into the possession or control of the lessor upon termination or forfeiture of the lease. In such cases, if the income includible is abnormal either in kind or in amount, the resulting item of net abnormal income shall be allocated in accordance with the following rules:

(*a*) If the lease has not been canceled or forfeited, but has merely expired, the amount of such item shall be spread over the life of the lease;

(*b*) If the lease has been canceled or forfeited, but the remaining useful life of the improvement is not in excess of what would have been the remaining life of the lease had the cancelation or forfeiture not occurred, the amount of such item shall be spread over what would have been the remaining life of the lease;

(*c*) If the lease has been canceled or forfeited and the remaining useful life of the improvement is in excess of what would have been the remaining life of the lease had the cancelation or forfeiture not occurred, then—

(1) An amount which bears the same ratio to the item of net abnormal income as the period which would have constituted the remaining life of the lease bears to the remaining useful life of the improvement shall be spread over what would have been the remaining life of the lease, and

(2) The remaining portion of the item shall be spread over the life of the lease, including what would have been its remaining life had the cancelation or forfeiture not occurred.

Amounts attributed to each future taxable year are to be included in gross income for such year for the purpose of computing the excess profits tax. See section 30.721–5. This paragraph may be illustrated by the following example:

Example. On January 1, 1929, the A Corporation, which makes its income tax returns on the calendar year basis, leased to the X Corporation an unimproved site. The latter corporation completed a building on this site on June 30, 1931. Such lease was for a period of 20 years and by its terms expired on December 31, 1948. On July 1, 1940, the lease is forfeited and the building comes into the possession and control of the A Corporation. The value of the building as of such date is $100,000, and its remaining useful life is 16 years. The A Corporation did not, prior to 1940, derive gross income of this nature, nor did it report as gross income any amount with respect to the erection of the building. In 1940 there were no direct costs or expenses attributable to the realization of such income. The net abnormal income for this item is, therefore, $100,000. Since the remaining useful life of the improvement is 16 years, but what would have been the remaining life of the lease is only 8½ years, $\frac{8\frac{1}{2}}{16}$ of $100,000, or $53,125, is to be spread over what would have been the remaining life of the lease, *i. e.*, the last half of 1940, and the calendar years 1941 to 1948, both inclusive. Since there are 17 half-years in such period, $\frac{1}{17}$ of $53,125, or $3,125, is to be allocated to the last half of 1940, and $\frac{2}{17}$ of $53,125, or $6,250, to each of the calendar years 1941 to 1948, both inclusive. The remainder of the $100,000 item, or $46,875

($100,000 minus $53,125), is to be spread over the years 1929 to 1948, both inclusive, *i. e.*, 1/20 of $46,875, or $2,343.75, is to be allocated to each such year. The total amount allocable to each year is as follows:

Years:	Amount per year.
1929–1939	$2,343.75
1940—	
Portion of $53,125 allocated to last half of year	3,125.00
Plus: Portion of $46,825 allocated to such year	2,343.75
Total	5,468.75
1941–1948—	
Portion of $53,125 allocated to each year	6,250.00
Plus: Portion of $46,825 allocated to each year	2,343.75
Total	8,593.75

The amounts allocated to the years 1929 to 1939, both inclusive, will have no effect upon the computation of the excess profits tax. The excess profits tax for the taxable year 1940 is to be determined by taking into gross income for such year only $5,468.75 of the $100,000 item otherwise includible. The amounts attributed to future years must be included in gross income for such years for the purpose of computing the excess profits tax, as provided in section 30.721–5.

Other items of net abnormal income resulting from the termination of the lease are to be attributed to the taxable year in which such items are realized and prior or subsequent taxable years in the light of the agreement underlying the realization of such items. If, for instance, the lessee pays the lessor a lump sum as consideration for the cancellation of a lease, the resulting item of net abnormal income, if any, shall be attributed ratably to the taxable years included in what would have been the remaining life of the lease had such lease not been canceled.

PAR. 24. Section 30.721–7 is renumbered section 30.721–11, and is amended to read as follows:

SEC. 30.721–11. *Dividends on stock of foreign corporations other than foreign personal holding companies.*—The sixth class of potentially abnormal income specifically set forth in section 721(a)(2) is dividends on stock of foreign corporations, except foreign personal holding companies. This section is applicable only to the extent that such dividends are not excluded from excess profits net income under section 711(a)(2)(A), and therefore does not apply in the computation of the excess profits tax when the excess profits credit based on invested capital is used unless the stock on which the dividends were received is not a capital asset. In determining whether the class of income described in this section is abnormal or in excess of 125 per cent of the average income of the same class for the four preceding taxable years, only dividends received from foreign corporations are to be taken into account. The exception relative to dividends from foreign personal holding companies applies both to distributions actually received from foreign personal holding companies and to constructive dividends deemed to have been received pursuant to section 337.

Items of net abnormal income of the class herein described are to be attributed to the years in which were accumulated the earnings and profits out of which the distributions were made, if accumulated after the acquisition by the distributee of the stock of the distributing corporation. If the earnings and profits out of which the distribution is made were accumulated prior to such acquisition, the income arising out of the distribution is to be attributed to the taxable year in which the stock was acquired. The earnings and profits out of which any distribution is made are, as provided in section 115, the most recently accumulated earnings and profits.

This section may be illustrated by the following example:

Example. The X Corporation, a domestic corporation, computing its excess profits credit on the income basis, acquired in 1938 all of the stock of the Y Company, Ltd., a foreign corporation, which is not a foreign personal holding company. The Y Company, Ltd., paid in July, 1940, a dividend to the X Corporation in the amount of $100,000. The X Corporation did not previously receive dividends from this or any other foreign corporation. In 1940 there were no direct costs or expenses attributable to the receipt of this dividend. The $100,000 is therefore a

single item of net abnormal income. The Y Company, Ltd., had earnings and profits of $75,000 in 1940 and $125,000 in 1939. Following principles of existing law with respect to the source from which dividends are deemed to have been paid, the $100,000 item of net abnormal income shall be allocated between the years 1940 and 1939 in the respective sums of $75,000 and $25,000. See section 115(b) and corresponding provisions of prior revenue laws. For method of computation of the excess profits tax for the year 1940, see section 30.721–4 and the example in section 30.721–6.

PAR. 25. Section 30.722–1 is stricken out and there is inserted in lieu thereof the following:

SEC. 6. ABNORMAL BASE PERIOD EARNINGS. (Excess Profits Tax Amendments of 1941.)

Section 722 of the Internal Revenue Code is amended to read as follows:

"SEC. 722. ADJUSTMENT OF ABNORMAL BASE PERIOD NET INCOME.

"(a) GENERAL RULE.—In the case of a taxpayer whose first taxable year under this subchapter begins in 1940, if the taxpayer establishes—

"(1) that the character of the business engaged in by the taxpayer as of January 1, 1940, is different from the character of the business engaged in during one or more of the taxable years in its base period (as defined in section 713(b)(1)); or

"(2) that in one or more of the taxable years in such base period normal production, output, or operation was interrupted or diminished because of the occurrence of events abnormal in the case of such taxpayer; and

"(3) the amount that would have been its average base period net income—

"(A) if the character of the business as of January 1, 1940, had been the same during each of the taxable years of such base period; and

"(B) if none of the abnormal events referred to in paragraph (2) had occurred; and

"(C) if in each of such taxable years none of the items of gross income had been abnormally large, and none of the items of deductions had been abnormally small; and

"(4) that the amount established under paragraph (3) is greater than the average base period net income computed under section 713(d) or section 742, as the case may be,

then the amount established under paragraph (3) shall be considered as the average base period net income of the taxpayer for the purposes of this subchapter.

"(b) RULES FOR APPLICATION OF SUBSECTION (a).—For the purposes of subsection (a)—

(1) High prices of materials, labor, capital, or any other agent of production, low selling price of the product of the taxpayer, or low physical volume of sales owing to low demand for such product or for the output of the taxpayer, shall not be considered as abnormal.

"(2) The character of the business engaged in by the taxpayer as of January 1, 1940, shall be considered different from the character of the business engaged in during one or more of the taxable years in its base period only if—

"(A) there is a difference in the products or services furnished; or

"(B) there is a difference in the capacity for production or operation; or

"(C) there is a difference in the ratio of nonborrowed capital to total capital; or

"(D) the taxpayer was in existence during only part of its base period; or

"(E) the taxpayer acquired, before January 1, 1940, all or part of the assets of a competitor, with the result that the competition of such competitor was eliminated or diminished.

"(3) The average base period net income determined under subsection (a)(3) shall be computed in the same manner as provided in section 713(d), except paragraphs (2) and (4), but for such purposes computing excess profits net income and deficit in excess profits net income on the basis of the assumptions made in subsection (a)(3).

"(4) If subsection (a)(1), or both subsections (a)(1) and (a)(2) are applicable to any taxpayer, its average base period net income under subsection (a)(3) shall not exceed the excess profits net income (as computed for the purposes of subsection (a)(3)) for the last taxable year in such base period. For the purposes of this paragraph, if such last taxable year is of less than twelve months, the excess profits net income for such taxable year shall be placed on an annual basis by multiplying by twelve and dividing by the number of months included in such taxable year.

"(c) LIMITATION ON APPLICATION OF GENERAL RULE.—This section shall not be applicable unless—

"(1) the tax under this subchapter for the taxable year computed without reference to this section, exceeds 6 per centum of the taxpayer's normal-tax net income for such year; and

"(2) the application of this section would result in a diminution of the tax otherwise payable under this subchapter for the taxable year by more than 10 per centum thereof.

"(d) EXTENT OF REDUCTION IN TAX UNDER THIS SECTION.—The application of this section shall not reduce the tax payable under this subchapter for the taxable year below 6 per centum of the taxpayer's normal-tax net income for such year. The tax under this subchapter computed with the application of subsection (a) shall be increased by an amount equal to 10 per centum of the tax computed without reference to this section.

"(e) APPLICATION FOR RELIEF UNDER THIS SECTION.—The taxpayer shall compute its tax and file its return under this subchapter without the application of this section. The benefits of this section shall not be allowed unless the taxpayer, within six months from the date prescribed by law for the filing of its return, makes application therefor in accordance with regulations to be prescribed by the Commissioner with the approval of the Secretary, except that if the Commissioner in the case of any taxpayer with respect to the tax liability of any taxable year—

"(1) issues a preliminary notice stating a deficiency in the tax imposed by this subchapter such taxpayer may, within ninety days after the date of such notice, make such application, or

"(2) mails a notice of deficiency (A) without having previously issued a preliminary notice thereof or (B) within ninety days after the date of such preliminary notice, such taxpayer may claim the benefits of this section in its petition to the Board or in an amended petition in accordance with the rules of the Board.

If the application is not filed within six months after the date prescribed by law for the filing of the return, the application of this section shall not reduce the tax otherwise determined under this subchapter by an amount in excess of the amount of the deficiency finally determined under this subchapter without the application of this section. If the average base period net income has been determined under subsection (a) for any taxable year, the Commissioner may, by regulations approved by the Secretary, prescribe the extent to which the limitations prescribed by this subsection may be waived for the purpose of determining the tax under this subchapter for a subsequent taxable year."

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of the enactment of the Excess Profits Tax Act of 1940.

SEC. 30.722–1. *General rule for adjustment of abnormal base period net income.*—In computing the excess profits credit based on income, taxpayers whose first excess profits tax taxable year begins in 1940 may, under the conditions stated in section 722 and subject to the limitations thereof, obtain relief with respect to abnormalities in their base period net income.

Section 722 sets forth the following specific tests which the taxpayer must meet to obtain the benefit thereof:

(*a*) The taxpayer must first establish—

(1) that the character of its business engaged in as of January 1, 1940, was different from the character of its business engaged in during one or more of the taxable years in its base period (as defined in section 713(b)(1)), or

(2) that the normal production, output, or operation in one or more of the taxable years in the base period was interrupted or diminished because of events abnormal in the case of the taxpayer.

(*b*) The taxpayer must next establish the amount that would have been its average base period net income—

(1) if the character of its business as of January 1, 1940, had been the same during each of the taxable years of its base period, and

(2) if none of the abnormal events referred to in (a)(2) above had occurred, and

(3) if in each of such taxable years the gross income of any class had not been abnormally large and the deductions of any class had not been abnormally small.

(*c*) The taxpayer must then show that the amount established under (*b*) above is greater than the average base period net income computed under section 713(d) or section 742, as the case may be.

If the foregoing tests are met, then the amount established under (*b*) above shall be considered as the average base period net income of the taxpayer for the purpose of computing the taxpayer's excess profits credit based on income. See, however, sections 30.722–4 and 30.722–5.

SEC. 30.722–2. *Rules for establishing a change in character of business or interruption of production.*—(*a*) *Change in character of business.*—The character of the business engaged in by the taxpayer as of January 1, 1940, is considered different from the character of the business engaged in during one or more of the taxable years in its base period only if:

(1) There is a difference in the products or services furnished. A product or service is different from another product or service if the trade custom or practice treats it as a product or service of a different class. A mere improvement in a product or service does not constitute a difference in the product or service. For example, a corporation in one year of its base period was engaged in both the radio broadcasting business and the department store business and on January 1, 1940, was engaged only in the radio broadcasting business, the department store business having been discontinued. The corporation is deemed to have changed the character of its business. The same is true where a corporation was engaged in one of the base period years in both the wholesale and retail dry goods business and on January 1, 1940, was engaged only in the retail dry goods business.

(2) There is a difference in the capacity for production or operation. Thus, for example, a corporation may have enlarged the size or capacity of its plant substantially as compared with the previous size or capacity of its plant or may have increased its capital substantially as compared with its previous capital.

(3) There is a difference in the ratio of nonborrowed capital to total capital. A corporation which during the base period was operating largely on borrowed capital but as of January 1, 1940, was operating largely on equity capital is deemed to have such difference.

(4) The taxpayer was in existence during only part of its base period. An example is where a corporation in 1938 organized into two or more new corporations. The new corporations were in existence for only a part of the base period. Similarly, any other corporation organized less than 48 months prior to its first excess profits tax taxable year was in existence for only a part of its base period.

(5) The taxpayer acquired before January 1, 1940, all or part of the assets of a competitor with the result that the competition of such competitor was eliminated or diminished. For example, two competing newspapers were operating at a loss during all or part of the base period. Prior to January 1, 1940, the first newspaper purchased the franchises and other assets of the second newspaper and as a result of this transaction the condition of the surviving paper was much more promising. A difference in the character of the business of the taxpayer has occurred.

(*b*) *Interruption or diminution of normal production, output, or operation in the base period.*—A taxpayer may secure relief under section 722 if it establishes that its normal production, output, or operation in one or more taxable years in its base period was interrupted or diminished because of events abnormal in the

case of the taxpayer. Not every interruption or diminution of normal production, output, or operation is a reason for establishing a different average base period net income. The interruption or diminution must be the direct result of an event abnormal for the taxpayer. In general, an event is abnormal for the taxpayer if in the light of the taxpayer's business experience it is not a usual event. High prices of materials, labor, capital, or any other agent of production, low selling price of the product of the taxpayer, or low physical volume of sales owing to low demand for such product or for the output of the taxpayer, are not abnormal. Abnormal events might include a flood, a fire, a strike, or any other unusual event hindering production, output, or operation. As to what constitutes normal production, output, or operation, see section 30.722–3(c).

SEC. 30.722–3. *Determination of substitute average base period net income.*—(a) *Average base period net income under normal conditions: in general.*—Having established a change in the character of its business or an interruption or diminution of normal production, output, or operation in accordance with section 30.722–2, the taxpayer must establish the amount that would have been its average base period net income from the beginning of its base period (1) if it had been engaged during its entire base period in a business of the same character as that engaged in as of January 1, 1940, and (2) if its normal production, output, or operation had not been interrupted or diminished at any time during the base period by events abnormal for the taxpayer, and (3) if, in each of such taxable years, its gross income of any class had not been abnormally large and its deductions of any class had not been abnormally small. What would have been the average base period net income of the corporation under such circumstances is a question to be determined upon consideration of all the facts in the particular case. No definite and conclusive tests can be prescribed by which it can be determined finally in advance of an examination of the facts of each case what substitute average base period net income may be established.

Among the factors in the base period which may be material in determining a substitute average base period net income are general business conditions, competition, and demand for the products or services of the class produced or rendered by the taxpayer. High prices of materials, labor, capital or any other agent of production, low selling price of the product, and low physical volume of sales owing to low demand for such products or output during the base period are all factors to be taken into consideration and are not to be treated as abnormal. Thus, for example, in the case of a corporation which in 1939 changed the character of its business from the manufacture of typewriter parts to the manufacture of rifles, a reconstruction of the excess profits net income of such a corporation for the taxable years in its base period as a manufacturer of rifles would have to take into consideration, among other factors, the actual demand for such rifles in 1936, 1937, and 1938.

For taxable years in which the excess profits net income of the taxpayer is to be reconstructed, the taxpayer must establish what its excess profits net income would have been under the conditions set forth in section 722(a)(3) for each of such years computed with the adjustments provided in section 711(b). The taxpayer's substitute average base period net income is then to be computed in accordance with section 713(d) (1) and (3), that is, without regard to any hypothetical excess profits net income computed under section 713(d)(2) and without regard to the provisions of section 742.

(b) *Where there was a change in the character of the business.*—In determining the substitute average base period net income of a taxpayer which as of January 1, 1940, was engaged in a business of a different character from that engaged in during one or more of the taxable years in the base period, one of the factors to be considered is the previous business experience of the same corporation or preexisting business enterprise during the base period. Thus, if a corporation is reorganized in the base period into two new corporations, the excess profits net income of each of the new corporations for the taxable years in the base period in which each was not in existence may be determined from that part of the business of the original corporation operated by each of the new corporations and that part of the excess profits net income of the original corporation attributable to such part of the business.

In no case may the amount of the average base period net income established by reason of a change in the character of the taxpayer's business exceed the excess profits net income as established for the last taxable year in the base period. If such taxable year consists of less than 12 months the excess profits net income for such taxable year shall be placed on an annual basis by multiplying by 12

and dividing by the number of months included in such taxable year. The method of determining the average base period net income may be illustrated by the following example:

Example. The X Newspaper Corporation, whose fiscal year ended March 31, 1940, acquired the franchises and other assets of a rival newspaper in December, 1939. Prior to that date, both newspapers had operated at a loss. After such acquisition, the X Newspaper Corporation showed a large profit. The corporation establishes that if it had possessed the assets of the rival newspaper during its entire base period its excess profits net income for its taxable years in the base period would have been as follows:

Fiscal year ending—	*Excess profits net income.*
March 31, 1937	$310,000
March 31, 1938	320,000
March 31, 1939	290,000
March 31, 1940	300,000

The average base period net income of the X Newspaper Corporation computed under section 713(e) is $305,000. Since, however, under section 722(b)(4) the highest amount which may be substituted for the average base period net income is the amount of excess profits net income established for the last taxable year of the base period, the substitute average base period net income is $300,000.

If the difference in the character of the business engaged in by a corporation as of January 1, 1940, is that it was in existence during only part of its base period, the excess profits net income for all of its taxable years in the base period may have to be established. The taxable years in the base period during which such a corporation was not in existence are successive periods of 12 months each, beginning with the forty-eighth month preceding the beginning of its first taxable year under the excess profits tax. Any remaining period of less than 12 months during which it was not in existence is considered a taxable year. The determination of such a corporation's average base period net income 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 July 1, 1937, as a result of the reorganization of the X Corporation into two new corporations. The excess profits net income of the Y Corporation computed with the adjustments provided in section 711(b) for the years 1938, 1939, and that portion of the year 1937 during which it was in existence is as follows:

Year—	*Excess profits net income.*
1937	$40,000
1938	20,000
1939	150,000

Based on this experience and in accordance with the principles set forth in (*a*) of this section, the Y Corporation establishes that its excess profits net income for 1936, 1937, 1938, and 1939 would have been as follows:

Year—	*Excess profits net income.*
1936	$62,000
1937	70,000
1938	300,000
1939	200,000

The average base period net income of the Y Corporation, whether computed under section 713(e) or section 713(f), can not under section 722(b)(4) exceed $200,000.

(*c*) *Where there was an interruption or diminution of normal production, output, or operation.*—If the taxpayer establishes that its normal production, output, or operation in one or more years in the base period was interrupted or diminished because of events abnormal in the case of the taxpayer, it must then establish what its average base period net income would have been if its base period normal production, output, or operation had not been so interrupted or diminished. The taxpayer's normal production, output, or operation may be determined from its average production, output, or operation with respect to products or services of the same class. Such average production, output, or

operation may be established by the average amount of production, output, or operation in the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, then for the previous taxable years during which it was in existence and so many of the succeeding taxable years ending before June 1, 1940, as do not make the total taxable years in the test period more than four. The average production, output, or operation determined should, however, be adjusted in accordance with the principles set forth in (*a*) of this section for changes in prices, demand, the condition of the business engaged in by the taxpayer, and other relevant business factors occurring in the period in which the abnormal event affected the production, output, or operation of the taxpayer and not occurring in the test period. The average production, output, or operation, as adjusted, is the taxpayer's normal production, output, or operation. For the taxable years in the base period in which, as a direct result of an abnormal event established in accordance with section 30.722–2(*b*), such normal production, output, or operation was not attained the taxpayer's excess profits net income should be reconstructed as if for such period the taxpayer had attained such normal production, output, or operation. In establishing what would have been its average base period net income under section 722(a)(3)(B), the taxpayer is limited, in the adjustments which it may make, to adjustments for such interruptions and diminutions of normal production, output, or operation as it establishes under section 30.722–2(*b*).. The abnormal event, however, need not have occurred in the base period as long as its consequences are directly reflected in production, output, or operation in the base period. For example, if a fire in 1935 had destroyed a taxpayer's plant so that the taxpayer's normal production in 1936 was diminished, the taxpayer would be permitted to establish what its excess profits net income would have been if its normal production had existed in 1936.

(*d*) *Where there are both a change of business and an interruption of normal production.*—If a taxpayer establishes both a change in the character of its business and the occurrence of an abnormal event interrupting or diminishing its normal production, output, or operation in the base period, the taxpayer must then establish what its average base period net income would have been as set forth in (*b*) and (*c*) of this section. However, such a taxpayer is subject to the limitation that its average base period net income thus determined can not exceed the amount established under this section as the amount that would have been the excess profits net income for the last taxable year in the base period. If such taxable year consists of less than 12 months the excess profits net income for such taxable year shall be placed on an annual basis by multiplying by 12 and dividing by the number of months included in such year.

(*e*) *Abnormalities in gross income and deductions.*—In establishing the substitute average base period net income, the taxpayer must establish what its average base period net income would have been if in each of the taxable years in its base period no class of gross income had been abnormally large in amount and no class of deductions had been abnormally small in amount. The adjustments to be made under section 722(a)(3)(C) are to be made only in classes of gross income and classes of deductions which are abnormal in amount but not as the result of a difference in the character of the business or an interruption or diminution in the normal production, output, or operation caused by an abnormal event, established under section 30.722–2.

In general, a class of gross income is abnormally large to the extent such class of gross income is larger in amount than 125 per cent of the average amount (determined as provided below) of the taxpayer's gross income of the same class, and a class of deductions is abnormally small to the extent the amount of deductions of such class is smaller than 75 per cent of the average amount (determined as provided below) of the taxpayer's deductions of the same class. In such a case, the average amount of gross income of the same class or of deductions of the same class shall be determined by averaging the amounts of such class in the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, then for the previous taxable years during which it was in existence and so many of the succeeding taxable years ending before June 1, 1940, as do not make the total taxable years in the test period more than four. In determining the average amount of any class of gross income or deductions by which an abnormality is to be measured for any year, the amount of gross income or of deductions for a year in the base period for which there was a difference in the character of the business or an interruption or diminution of normal production, output, or operation caused

by an abnormal event is the amount of gross income or deductions established for such year; the amount of gross income or deductions of any class adjusted as provided herein shall be used in computing the average amount of gross income or deductions of such class for the application of section 722(a)(3)(C) to a subsequent taxable year. However, if the taxpayer establishes that the disproportion in the amount of gross income or deductions of any class for any year is a consequence of high prices of materials, labor, capital, or any other agent of production, low selling price of the product of the taxpayer, or low physical volume of sales owing to low demand for such product or for the output of the taxpayer, or of a change at any time in the type, manner of operation, size, or the condition of the business engaged in by the taxpayer, the gross income or deductions of such class are not required to be adjusted under section 722(a)(3)(C). That part of any class of gross income which is determined to be abnormally large, as herein provided, shall be eliminated from gross income. That part of any class of deductions determined to be abnormally small, as herein provided, shall be increased to the extent it is abnormally small. The rules for determining classes of deductions are set forth in section 711(b)(1)(H), (I), and (J), and the regulations prescribed thereunder. The rules for determining classes of gross income are set forth in section 721 and the regulations prescribed thereunder. The rule stated in the first sentence of this paragraph may be illustrated by the following examples:

Example (1). The X Corporation, which came into existence on January 1, 1936, and which makes its income tax returns on the calendar year basis, establishes that it is entitled to the benefits of section 722 because of an abnormal event interrupting normal production in 1937. For 1938, the corporation's deduction for interest on loans was $5,000. The average amount of the taxpayer's interest deduction is to be determined for 1936, 1937, and 1939. The taxpayer's deductions of the same class for those years were $14,000 for 1936, $9,000 for 1937, and $10,000 for 1939. The average interest deduction is therefore $11,000, and the interest deduction for 1938 for purposes of the substitute excess profits net income for 1938 should be $8,250 (75 per cent of $11,000).

Example (2). The gross income of the Y Hotel Corporation in 1939 from room rent was $1,000,000 because of a "World's Fair." The gross income from room rent in 1938 was $700,000. The corporation establishes that the hotel's gross income from room rent in 1937 would have been $600,000 if a strike, by reason of which the corporation was entitled to the benefits of section 722, had not occurred. The gross income of the same class in 1936 was $600,000, and in 1935 was $500,000. The average of the gross income of this class therefore was $600,000. The gross income from room rent in 1939 therefore should be reduced to $750,000 (125 per cent of $600,000).

In establishing the average base period net income as if none of the classes of gross income had been abnormally large in amount and none of the classes of deductions had been abnormally small in amount, the taxpayer's gross income and deductions should be adjusted to remove completely the effect of the abnormality. Complementary adjustments must be made in other classes of deductions and of gross income for any amount of gross income eliminated or of deductions increased. Thus, in example (2) above in connection with the elimination of $250,000 from gross income from room rent in 1939 there should be a corresponding decrease in the deductions for expenses directly incurred in obtaining that part of the gross income which was eliminated, such as the deduction for wages of any additional employees needed to earn the abnormally large gross income.

SEC. 30.722-4. *Limitation on application of general rule.*—The adjustments provided in section 722 shall not be operative in the case of any taxpayer unless such taxpayer establishes that its excess profits tax—

(*a*) when computed without reference to section 722, exceeds 6 per cent of its normal-tax net income for the taxable year, and

(*b*) when computed with the application of section 722(a), is an amount which is less than 90 per cent of the excess profits tax computed without reference to section 722.

As a necessary complement to these limitations, further provisions are made as to the amount of the excess profits tax in the case of a taxpayer entitled to the benefit of the adjustments provided in section 722(a). If the taxpayer meets the tests set forth in (*a*) and (*b*) above, then there shall be added to the tax computed after the application of section 722(a) an amount equal to 10 per cent of the amount of excess profits tax computed without reference to section 722. The resulting tax is the taxpayer's excess profits tax if it is not

less than 6 per cent of the taxpayer's normal-tax net income for the taxable year; if it is less than 6 per cent of the taxpayer's normal-tax net income, then the tax shall be an amount equal to 6 per cent of the normal-tax net income for the taxable year. The tax for the purpose of measuring the 6 per cent and 10 per cent limitations is the tax after the application of the foreign tax credit provided in section 729.

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

Example (1). The X Corporation which makes its income tax return on the calendar year basis has a normal-tax net income for 1940 of $500,000 and an adjusted excess profits net income computed without reference to section 722 of $200,000. The excess profits tax on such amount is $71,500, which is in excess of 6 per cent of the taxpayer's normal-tax net income for 1940. The corporation establishes that by reason of a flood in 1938 its normal production was interrupted and its excess profits net income for 1938 was $100,000, although it would have been $500,000 if such interruption had not occurred. The taxpayer's average base period net income computed under section 713(e) would have been $100,000 larger if its excess profits net income for 1938 were considered to be $500,000. All other facts remaining the same, the adjusted excess profits net income of $200,000 set forth above is to be reduced by the resulting $95,000 increase in the excess profits credit (95 per cent of $100,000, the increase in average base period net income). The adjusted excess profits net income for 1940 would be $105,000 and the excess profits tax on such amount would be $33,500. To such $33,500 there must be added the amount of $7,150 (10 per cent of the tax, $71,500, computed without reference to section 722) and, thus, the taxpayer's excess profits tax for 1940, computed with the application of section 722, is $40,650 ($33,500 plus $7,150).

Example (2). The normal-tax net income of the Y Corporation for the calendar year 1940 (its taxable year) is $200,000 and its adjusted excess profits net income computed without the benefit of section 722 is $50,000. The excess profits tax on this amount is $14,000, which is in excess of 6 per cent of the corporation's normal-tax net income for 1940. The Y Corporation meets the tests of section 722(a) and establishes that its adjusted excess profits net income for 1940 computed with the adjustments provided in section 722(a) would be $43,000. The excess profits tax on this amount would be $11,900. The Y Corporation is entitled to the relief provided under section 722 because the application of section 722(a) has reduced its tax by more than 10 per cent, and, when 10 per cent of the tax computed without reference to section 722 (10 per cent of $14,000, or $1,400) is added to the tax computed with the adjustments provided in section 722(a) ($11,900), the resulting excess profits tax, $13,300, is more than 6 per cent of the taxpayer's normal-tax net income for 1940.

SEC. 30.722-5. *Application for relief under section 722.*—(*a*) *In general.*—The taxpayer is not permitted to claim the benefit of section 722 in computing its excess profits tax upon its return, except as provided in (*c*) of this section. In order to obtain the benefits of section 722 for any taxable year a taxpayer within six months after the time prescribed by law for filing its excess profits tax return for such year must file under oath an application on Form 991 for the benefit of section 722, unless the provisions of (*b*) or (*c*) of this section are applicable to such taxpayer. For the purposes of this section, the time prescribed by law for filing the return includes the period of any extension of time granted by the Commissioner.

The application on Form 991 must be filed in duplicate with the Commissioner of Internal Revenue, Washington, D. C., attention of the Income Tax Unit, Clearing Division, Claims Control Section. Such application shall, in accordance with the provisions of this section and the instructions on the form, set forth the following information:

(1) The name and address of the corporation;

(2) The date and place of incorporation;

(3) The excess profits tax taxable year for which the benefits of section 722 are claimed;

(4) The collection district in which the excess profits tax return for such year was filed;

(5) The taxpayer's normal-tax net income and the amount of excess profits tax (after the application of the foreign tax credit) shown upon its return for such year;

(6) The date of the beginning of the taxpayer's first excess profits tax taxable year;

(7) The excess profits net income or deficit in excess profits net income for each taxable year in the base period, computed without regard to section 722;

(8) If a difference in the character of business is the basis of the application—

(i) the taxable years in the base period in which it is claimed that the character of the business was different from that as of January 1, 1940,

(ii) the subparagraph of section 722(b)(2) in which such difference falls,

(iii) the character of the business as of January 1, 1940,

(iv) the character of the business in each of the taxable years in the base period,

(v) the amount which would have been the taxpayer's excess profits net income for each taxable year in the base period in which its business was of a different character if the business had been the same in each of such years as that on January 1, 1940, and

(vi) a detailed statement showing how such amount was determined;

(9) If an interruption or diminution of normal production, output, or operation is the basis of the application—

(i) the abnormal events and the time of their occurrence,

(ii) the taxable years in which such abnormal events interrupted or diminished normal production, output, or operation, and

(iii) the production, output, or operation of the taxpayer for the taxable years in the base period and for the four taxable years immediately preceding the taxable year in which normal production, output, or operation was interrupted or diminished, or, if the taxpayer was not in existence for four previous taxable years, then for such previous taxable years as it was in existence and for so many of the succeeding taxable years ending before June 1, 1940, as do not make the total more than four;

(10) A schedule of the classes of gross income and deductions and the amounts thereof—

(i) for each of the taxable years in the base period (including the taxable years for which adjustments were made under section 722(a)(3)(A) and (B) and the amounts of any classes of gross income or deductions established thereunder),

(ii) for each subsequent taxable year beginning after December 31, 1939, and ending before June 1, 1940, and

(iii) for each of the four taxable years preceding the first taxable year in the base period;

(11) The excess profits net income or deficit in excess profits net income established for each taxable year in the base period after all adjustments under section 722;

(12) A statement showing the extent to which any class of income or deductions appearing in the schedule required in (10) above and abnormal in amount as determined under section 30.722-3(c) is a result of high prices of materials, labor, capital, or any other agent of production, low selling price of the product of the taxpayer, or low physical volume of sales owing to low demand for such product or for the output of the taxpayer, or of a change at any time in the type, manner of operation, size, or the condition of the business engaged in by the taxpayer;

(13) The average base period net income determined under section 722(a)(3);

(14) The average base period net income determined without regard to section 722; and

(15) Such other information as may be required by the instructions appearing on Form 991 or issued therewith.

The application on Form 991 shall be considered a claim for refund or credit with respect to the excess profits tax for the taxable year paid at or prior to the time such application is filed. In case the taxpayer elects to pay in installments the tax shown upon its return and at the time the application is filed such tax has not been paid in full, the taxpayer should file a claim for refund or credit on Form 843 as promptly as possible after such tax has been paid in full. The information already submitted in the application need not again be submitted on Form 843 if reference is made therein to such application. For limitations upon refunds and credits generally, see section 322. As to procedure upon disallowance of a claim for refund relating to abnormalities, see section 732.

(*b*) *After assertion of deficiency.*—If a taxpayer does not file an application under (*a*) of this section within the 6-month period provided in section 722(e), it may nevertheless obtain relief under section 722 if there is a deficiency in excess profits tax asserted against it. In such case, the application of section 722 shall not reduce the excess profits tax determined without reference to such section by an amount in excess of the amount of the deficiency finally determined without reference to such section.

If a preliminary notice of deficiency is issued, the taxpayer may obtain the limited benefits of section 722 described in the preceding paragraph by filing an application on Form 991 within 90 days after the date of such notice, regardless of when or whether a formal notice of deficiency is issued. (See section 272(a).) If a formal notice of deficiency is issued without the issuance of a preliminary notice or within 90 days after the issuance of a preliminary notice, the taxpayer may claim such benefits in its petition, or amended petition, to the Board of Tax Appeals filed in accordance with the rules of the Board and with respect to the deficiency asserted in such formal notice. If, however, a preliminary notice is issued and the taxpayer does not file a timely application on Form 991, and a formal notice of deficiency is issued after the expiration of 90 days from the date of the preliminary notice, the taxpayer can not claim the benefits of section 722 in a petition, or amended petition, filed with the Board of Tax Appeals.

A taxpayer filing an application on Form 991 after a preliminary notice of deficiency shall attach to such application a copy of such notice.

(*c*) *Waiver of limitations for subsequent taxable years.*—If a taxpayer files an application on Form 991 for a taxable year as provided in (*a*) or (*b*) of this section, then in filing an application for a subsequent taxable year under (*a*) or (*b*) of this section the information required in (*a*) (8), (9), (10), and (12) of this section need be supplied only to the extent that such information would differ from that set forth in the prior application, provided reference is made to such prior application. If the average base period net income of the taxpayer is finally determined under section 722(a)(3), or if permission is granted by the Commissioner after a determination which has not become final, such taxpayer, in computing its excess profits tax in any return required to be filed thereafter, may, without the filing of any application on Form 991 but subject to the limitations of section 722 (c) and (d), use as its average base period net income the average base period net income thus determined, except as further adjustments may be required by section 711(b).

PAR. 26. Section 30.725–3 is amended by striking out the second paragraph thereof.

PAR. 27. The following is inserted immediately preceding section 30.729–1:

SEC. 16. COMPUTATION OF CREDITS ON RETURNS. (Excess Profits Tax Amendments of 1941.)

Section 729(b) of the Internal Revenue Code is amended by striking out "(b) RETURNS.—" and inserting in lieu thereof the following:

"(b) RETURNS.—

"(1) COMPUTATION OF EXCESS PROFITS CREDITS.—In the case of a taxpayer which under section 712 or section 741 is entitled to have the excess profits credit computed under section 713 or section 714, whichever results in the lesser tax under this subchapter, the return under this subchapter for any taxable year shall contain computations of two tentative taxes, one with the credit computed under section 713 and one with the credit computed under section 714; and the return shall contain all information which the Commissioner, by regulations prescribed by him with the approval of the Secretary, may prescribe as necessary for such computations. If the taxpayer states in such return that it disclaims the use of one of such credits in the computation of the tax under this subchapter for the taxable year, the computation and information based on such credit may be omitted from the return.

"(2) NO RETURN REQUIRED.—."

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

PAR. 28. Section 30.729–1 is amended as follows:

(A) By changing the heading to read: "*Time and place for filing returns and information to be included.*"

(B) By inserting at the end thereof the following new paragraph:

Any taxpayer which is entitled to have its excess profits credit computed under section 713 or section 714, whichever credit results in the lesser excess profits tax, is required to file a return on Form 1121 (revised), and such return shall (unless the taxpayer states therein that it disclaims the use of one of the credits) contain computations of the credits computed under section 713 and section 714 and the excess profits net income computed with the credit under section 713 and the excess profits net income computed with the credit under section 714, and shall contain all the information required by such form and by these regulations with respect to such computations. A taxpayer stating in its return that it disclaims the use of one of the credits in the computation of the excess profits tax for the taxable year may omit from the return the computation and information upon which such disclaimed credit would be based.

PAR. 29. The following is inserted immediately preceding section 30.730–1:

SEC. 7. CONSOLIDATED RETURNS OF INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL. (Excess Profits Tax Amendments of 1941.)

Section 730(e)(6) of the Internal Revenue Code is amended to read as follows:

"(6) Insurance companies subject to taxation under section 201 or 207."

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

PAR. 30. Section 30.730–3 is amended as follows:

(A) By striking out the fourth sentence of the first paragraph and inserting in lieu thereof the following:

For instance, there will not be recognized as an affiliated group two non-insurance corporations the common parent corporation of which is a personal holding company or an insurance company taxable under section 201 or section 207.

(B) By striking out the second paragraph and inserting in lieu thereof the following:

An insurance company taxable under section 201 may be included in an affiliated group with other insurance companies taxable under section 201 but may not be included in an affiliated group with other corporations. Similarly, an insurance company taxable under section 207 may be included in an affiliated group with other insurance companies taxable under section 207 but may not be included in an affiliated group with other corporations. On the other hand, an insurance company taxable under section 204 may be included in an affiliated group with corporations other than insurance companies taxable under section 201 or section 207.

PAR. 31. The following is inserted immediately following section 30.731–1:

SEC. 9. PROCEDURAL PROVISIONS. (Excess Profits Tax Amendments of 1941.)

Part 1 of subchapter E of chapter 2 of the Internal Revenue Code is amended by inserting at the end thereof the following new section:

"SEC. 732. REVIEW OF ABNORMALITIES BY BOARD OF TAX APPEALS.

"(a) PETITION TO THE BOARD.—If a claim for refund of tax under this subchapter for any taxable year is disallowed in whole or in part by the Commissioner, and the disallowance relates to the application

of section 711(b)(1) (H), (I), (J), or (K), section 721, or section 722, relating to abnormalities, the Commissioner shall send notice of such disallowance to the taxpayer by registered mail. Within ninety days after such notice is mailed (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) the taxpayer may file a petition with the Board of Tax Appeals for a redetermination of the tax under this subchapter. If such petition is so filed, such notice of disallowance shall be deemed to be a notice of deficiency for all purposes relating to the assessment and collection of taxes or the refund or credit of overpayments.

"(b) DEFICIENCY FOUND BY BOARD IN CASE OF CLAIM.—If the Board finds that there is no overpayment of tax in respect of any taxable year in respect of which the Commissioner has disallowed, in whole or in part, a claim for refund described in subsection (a) and the Board further finds that there is a deficiency for such year, the Board shall have jurisdiction to determine the amount of such deficiency and such amount shall, when the decision of the Board becomes final, be assessed and shall be paid upon notice and demand from the collector.

"(c) FINALITY OF DETERMINATION.—If in the determination of the tax liability under this subchapter the determination of any question is necessary solely by reason of section 711(b)(1) (H), (I), (J), or (K), section 721, or section 722, the determination of such question shall not be reviewed or redetermined by any court or agency except the Board."

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

SEC. 30.732–1. *Review of abnormalities by Board of Tax Appeals.*—Section 732 provides that, in addition to its jurisdiction to redetermine a deficiency, the Board of Tax Appeals shall have jurisdiction to review the Commissioner's disallowance of a claim for refund of excess profits taxes, if such disallowance involves the determination of any question relating solely to the application of section 711(b)(1) (H), (I), (J), or (K), section 721 or section 722, which sections have reference to abnormalities. The taxpayer's petition must be filed with the Board within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) after the sending by registered mail of the notice of disallowance of the claim for refund.

Where the taxpayer has filed such a petition the notice of disallowance of its claim for refund is considered to be a notice of deficiency for all purposes relating to the assessment and collection of taxes or the refund or credit of overpayments. If the Board finds that there has been no overpayment of tax with respect to the taxable year involved, and further finds that there is a deficiency for such year, the Board will determine the amount of such deficiency and such amount shall, when the decision of the Board becomes final, be assessed and paid upon notice and demand from the collector.

The extent and the finality of the Board's jurisdiction with respect to questions involving the application of the sections dealing with abnormalities are set forth in section 732(c) and may be illustrated by the following example:

Example. A taxpayer engaged in the production and refining of oil claims, with reference to a taxable year beginning in 1940, that 80 per cent of an item of gross income results from exploration carried on in prior years and is therefore within section 721(a)(2)(C). The Commissioner determines that only 40 per cent of such item is gross income resulting from exploration and therefore reaches a different result as to the amount of abnormal income of the class described in section 721(a)(2)(C). There is no dispute as to the total amount of the item of gross income. The controversy relates solely to the percentage thereof resulting from exploration. The Commissioner's determination is therefore upon an issue arising solely under section 721 and is reviewable only by the Board of Tax Appeals. If, however, the Commissioner also determines that the total amount of the item of gross income is greater than the amount reported by the taxpayer, the question as to such amount is not one arising solely by reason of section 721 but independently of it, and hence review of this question is not confined to the Board.

SEC. 10. CAPITALIZATION OF ADVERTISING, ETC., EXPENDITURES. (Excess Profits Tax Amendments of 1941.)

(a) Part 1 of subchapter E of chapter 2 of the Internal Revenue Code is amended by inserting at the end thereof the following new section:

"SEC. 733. CAPITALIZATION OF ADVERTISING, ETC., EXPENDITURES.

"(a) ELECTION TO CHARGE TO CAPITAL ACCOUNT.—For the purpose of computing the excess profits credit, a taxpayer may elect, within six months after the date prescribed by law for filing its return for its first taxable year under this subchapter, to charge to capital account so much of the deductions for taxable years in its applicable base period on account of expenditures for advertising or the promotion of good will, as, under rules and regulations prescribed by the Commissioner with the approval of the Secretary, may be regarded as capital investments. Such election must be the same for all such taxable years, and must be for the total amount of such expenditures which may be so regarded as capital investments. In computing the excess profits credit, no amount on account of such expenditures shall be charged to capital account:

"(1) For taxable years in the base period unless the election authorized in subsection (a) is exercised, or

"(2) For any taxable year prior to the beginning of the base period.

"(b) EFFECT OF ELECTION.—If the taxpayer exercises the election authorized under subsection (a)—

"(1) The net income for each taxable year in the base period shall be considered to be the net income computed with such deductions disallowed, and such deductions shall not be considered as having diminished earnings and profits. This paragraph shall be retroactively applied as if it were a part of the law applicable to each taxable year in the base period; and

"(2) The treatment of such expenditures as deductions for a taxable year in the base period shall, for the purposes of section 734 (b) (2), be considered treatment which was not correct under the law applicable to such year."

* * * * *

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

SEC. 30.733-1. *Scope of election to charge to capital account expenditures for advertising or the promotion of good will.*—Any taxpayer may, for the purpose of computing its excess profits credit under either the income or the invested capital method, elect to charge to capital account any deductions based upon expenditures for taxable years in its base period on account of advertising or the promotion of good will, to the extent that such expenditures may be regarded as capital investments under the regulations prescribed under section 733. Section 733 provides for an election with reference only to deductions for such expenditures for taxable years in the base period. In order to secure the benefits of that section, a taxpayer shall make its election within six months after the date prescribed by law for filing its return for its first excess profits tax taxable year.

The election under section 733 is an election to capitalize all the expenditures in each taxable year in the taxpayer's base period which were for advertising or the promotion of good will and which may be regarded as capital investments under the regulations prescribed under section 733. A taxpayer may not capitalize such expenditures for one base period taxable year and treat as a deduction such expenditures with respect to another base period taxable year. No such expenditures for any taxable year beginning prior to the taxpayer's base period may be charged to capital account. A taxpayer which has failed to make an election under section 733 is not permitted, in computing its excess profits credit, to charge to capital account base period expenditures for advertising or the promotion of good will which have been deducted for taxable years in such period.

SEC. 30.733-2. *Expenditures which may be regarded as capital investments.*—An expenditure for advertising or the promotion of good will may be regarded as a capital investment if, upon consideration of all the facts and circumstances

of the particular case, it may be regarded as made for the purpose of increasing the taxpayer's earning capacity over a substantial period subsequent to the taxable year in which such expenditure was made. The fact that a corporation failed, because of operating losses, to receive any benefits with respect to its income tax liability from deductions on account of expenditures is not evidence that such expenditures may be regarded as capital investments. In addition to those expenditures for capital items including good will which, under the provisions of section 24, may not be allowed as deductions, the following expenditures may in any case be regarded as capital investments within the contemplation of section 733:

(*a*) All advertising expenditures to promote a taxpayer's business in a territory new to such taxpayer, or to promote a new product, department, trade mark, trade brand, or trade name of such taxpayer, for the first 12 months after the taxpayer has begun to develop such new territory, or to promote such new product, department, trade mark, trade brand, or trade name. A new product within the meaning of this section does not include any product which is merely an improvement of an earlier product.

(*b*) All advertising expenditures for the taxable year to the extent that such expenditures exceed the taxpayer's average annual expenditures on account of advertising for the 48 months preceding the taxable year, or, if the taxpayer was not in existence during the whole of such 48-month period, then for the period during which the taxpayer was in existence.

Every item classifiable under this section as a capital investment constitutes a permanent asset of the taxpayer's business, and no deduction for depreciation will be allowed in respect of such an item.

A taxpayer electing under section 733 shall submit a statement containing complete information with respect to all expenditures made during its base period for advertising or the promotion of good will, classified as to those which are deductible and those which may be regarded as capital investments under that section. This statement shall set forth whether such expenditures were extraordinary in nature or amount and the purposes for which they were made. Such a taxpayer shall bear the burden of proving that those expenditures which it seeks to capitalize may be regarded as capital investments. It may not deduct similar expenditures made in any taxable year beginning after December 31, 1939, and shall submit the same complete information with respect to such expenditures.

SEC. 30.733-3. *Effect of election.*—Section 733 retroactively amends, for the purpose of determining the income tax liability and the excess profits credit of any taxpayer exercising an election under that section, the revenue laws applicable to each of such taxpayer's base period taxable years. Hence, the previous treatment as deductions of expenditures made during the base period for advertising or the promotion of good will which may be regarded as capital investments under the regulations prescribed under section 733 is an erroneous and inconsistent treatment. The normal-tax or special-class net income for each applicable base period taxable year must be recomputed with such expenditures disallowed as deductions, and both the excess profits net income for each such year and the earnings and profits account will be increased in the amount of such disallowed deductions.

The disallowance of deductions in the base period made necessary by this section requires a redetermination of the income tax liability for such years and any deficiencies in tax resulting from the disallowance of such deductions shall be assessed and collected under the internal revenue laws applicable with respect to the assessment and collection of deficiencies for such years. If, however, correction of the effect of the prior inconsistent treatment of such items in the base period years is prevented, within the meaning of section 734(b)(1)(C), correction shall be made by means of an adjustment under section 734. Since the amount of such an adjustment under section 734 is a part of the excess profits tax, which applies only to taxable years beginning after December 31, 1939, it does not decrease earnings and profits or excess profits net income for any period before the beginning of the taxpayer's first excess profits tax taxable year.

In the case of a taxpayer electing under section 733, the provisions of section 711(b)(1)(J), relating to abnormal deductions in the base period, do not affect deductions for expenditures for advertising or the promotion of good will which may be regarded as capital investments, since, in such a case, section 733 effects a disallowance of such deductions for income tax purposes before any of the adjustments under section 711(b)(1) are operative.

SEC. 11. ADJUSTMENT IN CASE OF INCONSISTENT POSITION. (Excess Profits Tax Amendments of 1941.)

Part 1 of subchapter E of chapter 2 of the Internal Revenue Code is amended by inserting at the end thereof the following new section:

"SEC. 734. ADJUSTMENT IN CASE OF POSITION INCONSISTENT WITH PRIOR INCOME TAX LIABILITY.

"(a) DEFINITIONS.—For the purposes of this section—

"(1) TAXPAYER.—The term 'taxpayer' means any person subject to a tax under the applicable revenue Act.

"(2) INCOME TAX.—The term 'income tax' means an income tax imposed by chapter 1 or chapter 2A of this title; Title I and Title IA of the Revenue Acts of 1938, 1936, and 1934; Title I of the Revenue Acts of 1932 and 1928; Title II of the Revenue Acts of 1926 and 1924; Title II of the Revenue Acts of 1921 and 1918; Title I of the Revenue Act of 1917; Title I of the Revenue Act of 1916; or section II of the Act of October 3, 1913; a war profits or excess profits tax imposed by Title III of the Revenue Acts of 1921 and 1918; or Title II of the Revenue Act of 1917; or an income, war profits, or excess profits tax imposed by any of the foregoing provisions, as amended or supplemented.

"(3) PRIOR TAXABLE YEAR.—A taxable year beginning after December 31, 1939, shall not be considered a prior taxable year.

"(b) CIRCUMSTANCES OF ADJUSTMENT.—

"(1) If—

"(A) in determining at any time the tax of a taxpayer under this subchapter an item affecting the determination of the excess profits credit is treated in a manner inconsistent with the treatment accorded such item in the determination of the income-tax liability of such taxpayer or a predecessor for a prior taxable year or years, and

"(B) the treatment of such item in the prior taxable year or years consistently with the determination under this subchapter would effect an increase or decrease in the amount of the income taxes previously determined for such taxable year or years, and

"(C) on the date of such determination of the tax under this subchapter correction of the effect of the inconsistent treatment in any one or more of the prior taxable years is prevented (except for the provisions of section 3801) by the operation of any law or rule of law (other than section 3761, relating to compromises),

then the correction shall be made by an adjustment under this section. If in a subsequent determination of the tax under this subchapter for such taxable year such inconsistent treatment is not adopted, then the correction shall not be made in connection with such subsequent determination.

"(2) Such adjustment shall be made only if there is adopted in the determination a position maintained by the Commissioner (in case the net effect of the adjustment would be a decrease in the income taxes previously determined for such year or years) or by the taxpayer with respect to whom the determination is made (in case the net effect of the adjustment would be an increase in the income taxes previously determined for such year or years) which position is inconsistent with the treatment accorded such item in the prior taxable year or years which was not correct under the law applicable to such year.

"(c) METHOD AND EFFECT OF ADJUSTMENT.—(1) The adjustment authorized by subsection (b), in the amount ascertained as provided in subsection (d), if a net increase shall be added to, and if a net decrease shall be subtracted from, the tax otherwise computed under this subchapter for the taxable year with respect to which such inconsistent position is adopted.

"(2) If more than one adjustment under this section is made because more than one inconsistent position is adopted with respect to one taxable year under this subchapter, the separate adjustments, each an amount ascertained as provided in subsection (d), shall be aggregated, and the aggregate net increase or decrease shall be added to or subtracted from

the tax otherwise computed under this subchapter for the taxable year with respect to which such inconsistent positions are adopted.

"(3) If all the adjustments under this section, made on account of the adoption of an inconsistent position or positions with respect to one taxable year under this subchapter, result in an aggregate net increase, the tax imposed by this subchapter shall in no case be less than the amount of such aggregate net increase.

"(d) ASCERTAINMENT OF AMOUNT OF ADJUSTMENT.—In computing the amount of an adjustment under this section there shall first be ascertained the amount of the income taxes previously determined for each of the prior taxable years for which correction is prevented. The amount of each such tax previously determined for each such taxable year shall be (1) the tax shown by the taxpayer, or by the predecessor, upon the return for such prior taxable year, increased by the amounts previously assessed (or collected without assessment) as deficiencies, and decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax; or (2) if no amount was shown as the tax by such taxpayer or such predecessor upon the return, or if no return was made by such taxpayer or such predecessor, then the amounts previously assessed (or collected without assessment) as deficiencies, but such amounts previously assessed, or collected without assessment, shall be decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax. There shall then be ascertained the increase or decrease in each such tax previously determined for each such year which results solely from the treatment of the item consistently with the treatment accorded such item in the determination of the tax liability under this subchapter. To the increase or decrease so ascertained for each such tax for each such year there shall be added interest thereon computed as if the increase or decrease constituted a deficiency or an overpayment, as the case may be, for such prior taxable year. There shall be ascertained the difference between the aggregate of such increases, plus the interest attributable to each, and the aggregate of such decreases, plus the interest attributable to each, and the net increase or decrease so ascertained shall be the amount of the adjustment under this section with respect to the inconsistent treatment of such item."

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

SEC. 30.734–1. *Purpose and scope of section 734.*—(*a*) *General.*—Section 734 provides for an adjustment if a determination of a taxpayer's excess profits tax liability treats an item or transaction affecting the excess profits credit inconsistently with the treatment of such item or transaction in the determination of the income tax liability of the taxpayer, or a predecessor, for a prior taxable year or years. The adjustment is not authorized unless (1) the treatment of the item or transaction for prior taxable years was incorrect under the law applicable to such years, (2) a correction of the effect of such erroneous treatment for one or more of the prior taxable years is prevented by the operation of a provision or rule of law, and (3) the inconsistent position adopted in the determination is asserted and maintained by the party (either the Commissioner or the taxpayer) who would be adversely affected by the adjustment.

(*b*) *Definitions.*—When used in sections 30.734–1 to 30.734–4, inclusive—

(1) The terms "taxpayer," "income tax," and "prior taxable year" shall have the meaning assigned to such terms by section 734(a). As to what constitutes a taxable year, see section 48(a).

(2) The term "predecessor" includes any taxpayer (other than the taxpayer whose excess profits tax liability is the subject of the determination) whose income tax liability for such prior taxable year would have been different if there had been no inconsistency between the treatment accorded an item or transaction in the determination of the excess profits tax liability of the taxpayer and the treatment accorded such item or transaction in the determination of its (i. e., the predecessor's) own income tax liability for such prior taxable year.

SEC. 30.734–2. *Circumstances of adjustment.*—(*a*) *Determination.*—A final determination of the excess profits tax liability is not a prerequisite to an adjustment

under section 734. Whenever there is a determination of the excess profits tax liability and the conditions prescribed in section 734(b) are satisfied, the adjustment is authorized as an essential part of the determination of such tax liability. For example, the making of the excess profits tax return required by section 729 or section 730 is a determination by the taxpayer; the assertion of a deficiency or the allowance or disallowance of a claim for refund is a determination by the Commissioner; and a decision by the Board of Tax Appeals or a court is a determination by such Board or court. If any such determination becomes final, the adjustment also becomes final. If, following a determination, there are further proceedings in the case and a subsequent determination which does not adopt the inconsistent treatment of the item or transaction, then no adjustment is authorized as a part of such subsequent determination.

(*b*) *Correction under ordinary procedure prevented.*—An adjustment is authorized only if, on the date of the determination of the excess profits tax liability, correction of the effect of the inconsistent treatment for one or more of the prior taxable years is prevented (except for the provisions of section 3801, relating to mitigation of effect of limitations and other provisions in income tax cases) by the operation, whether before, on, or after the date of enactment of section 734, of any provision of law (other than section 3761, relating to compromises) or rule of law. Such provisions or rules of law include, for example, statutes of limitations and res judicata.

The ascertainment of whether correction of the effect of the inconsistent treatment is prevented within the meaning of section 734(b)(1)(C) and this section must be made with respect to each income tax for each prior taxable year affected by the erroneous treatment of the item or transaction. Section 734 is not applicable in respect of any income tax for any prior taxable year if, on the date of the determination of the excess profits tax liability, correction of the effect of the erroneous treatment of the item is possible under the ordinary procedure applicable to the assessment and collection of deficiencies or the refund or credit of overpayments, as the case may be, in respect of such tax for such taxable year. See the example under section 30.734–4.

If correction of the effect of the erroneous treatment of the item or transaction with respect to an income tax for a prior taxable year is otherwise prevented, the application of section 734 is not precluded by the fact that the tax for such year may, under appropriate circumstances, be open to an adjustment under section 3801.

If any income tax liability for a prior taxable year has been compromised under section 3761, no adjustment may be made under section 734 with respect to the tax liability compromised.

(*c*) *Operation dependent upon maintenance of inconsistent position.*—An adjustment, with respect to an item or transaction, which would result in a net increase in the amount of the income taxes previously determined for prior taxable years is authorized only if (1) the taxpayer with respect to which the determination is made has, in connection with an item or transaction affecting the determination of its excess profits credit, maintained a position which is inconsistent with the erroneous treatment of such item or transaction for prior taxable years, and (2) such inconsistent position is adopted in the determination.

An adjustment, with respect to an item or transaction, which would result in a net decrease in the amount of the income taxes previously determined for prior taxable years is authorized only if (1) the Commissioner, in connection with an item or transaction affecting the determination of the taxpayer's excess profits credit, has maintained a position which is inconsistent with the erroneous treatment of such item or transaction for prior taxable years, and (2) such inconsistent position is adopted in the determination.

Inconsistent treatment within the meaning of section 734 may relate to the principle or rule of law applied in determining the taxable status of an item or transaction, or it may relate only to the amount of the item or transaction which is to be taken into account for tax purposes. The inconsistency is to be ascertained by reference to the actual treatment of the item or transaction for prior taxable years rather than to what the taxpayer or the Commissioner may have urged.

If a determination of the excess profits tax liability for one taxable year adopts with respect to an item or transaction an inconsistent position which results in an adjustment under section 734, similar treatment of the same item or transaction for subsequent excess profits tax taxable years does not authorize a further adjustment under such section.

(*d*) *Law applicable in determination of error.*—Whether there was an erroneous treatment of the item or transaction for prior taxable years is to be determined under the provisions of the internal revenue laws applicable with respect to such years. If the inconsistent treatment adopted in the determination of the excess profits tax liability is based upon an authoritative judicial interpretation of the applicable revenue law which differs from the interpretation of such law accepted in the determination of the tax liability for such prior years, then the treatment accorded the item or transaction for such prior years is erroneous within the meaning of section 734.

Section 734 does not authorize an adjustment if the difference between the treatment accorded an item or transaction in computing the excess profits credit and the treatment accorded such item or transaction in computing the tax liability for prior taxable years is occasioned solely by reason of an adjustment required by a specific provision of the Act, such as the adjustments required by section 711(b) to normal-tax net income and special-class net income in computing excess profits net income. Since the disallowances under section 733 of deductions on account of expenditures for advertising or the promotion of good will are not required by the Act but are merely permissive at the election of the taxpayer, and since section 733 specifically provides that, if an election is made, the treatment of such expenditures as deductions for prior taxable years shall be considered incorrect, an adjustment under section 734 may be authorized in the case of such a disallowance.

SEC. 30.734–3. *Method and effect of adjustment.*—The adjustment authorized by section 734, although measured by reference to the income taxes previously determined for prior taxable years, does not operate as an adjustment to the income tax liability for such years, but the amount of such adjustment is added to or subtracted from, as the case may be, the excess profits tax otherwise computed for the taxable year with respect to which the inconsistent position is adopted.

No adjustment with respect to an item or transaction is authorized unless the inconsistent position adopted in the determination is maintained by the party who would be adversely affected by such adjustment. See section 30.734–2(*c*). Accordingly, if a determination for one taxable year adopts inconsistent positions with respect to several items or transactions, it is necessary to make separate and distinct computations with respect to each such item or transaction in order to ascertain the amount of the potential adjustment with respect to each such item or transaction and whether an adjustment with respect to such item or transaction is authorized. If several adjustments are authorized with respect to one excess profits tax taxable year, the separate adjustments are aggregated and the aggregate net increase or net decrease is added to, or subtracted from, as the case may be, the excess profits tax otherwise computed for such taxable year. In ascertaining the amount of the adjustment with respect to a particular item or transaction, no effect shall be given to the computations made for the purpose of determining the amount of the adjustment with respect to any other item or transaction. If the several authorized adjustments result in an aggregate net increase, the excess profits tax liability for such taxable year shall not in any case be less than the amount of such aggregate net increase.

The amount of the credit for foreign taxes allowable under the provisions of section 729 shall be determined before giving effect to any adjustment under this section.

SEC. 30.734–4. *Ascertainment of amount of adjustment.*—To ascertain the amount of the adjustment, it is necessary to determine the amount of the increase or decrease in each income tax previously determined for each of the prior taxable years which would have resulted if the item or transaction erroneously treated had received the correct treatment under the law applicable with respect to such tax for such year. To each such increase or decrease there shall be added interest thereon computed as if the increase or decrease constituted a deficiency or an overpayment, as the case may be, with respect to such tax for such year. In all such cases interest shall be computed to the 15th day of the third month following the close of the excess profits tax taxable year with respect to which the determination of the excess profits tax liability is made.

If only one income tax for one prior taxable year is involved, the increase or decrease in such tax for such year plus the interest thereon is the amount of the adjustment with respect to the particular item or transaction.

If two or more income taxes for one prior taxable year, or two or more prior taxable years are involved, it is necessary to determine the increase or decrease in each income tax previously determined for each such year, plus the interest on each such increase or decrease. The difference between the sum of the increases, including the interest thereon, and the sum of the decreases, including the interest thereon, shall be ascertained and the net increase or net decrease so determined is the amount of the adjustment with respect to the particular item or transaction.

The computation to determine the increase or decrease in each income tax for each year shall be made as follows:

(*a*) The amount of the tax previously determined must first be ascertained. This may be the amount of tax shown on the taxpayer's return, but if any changes in that amount have been made they must be taken into account, including any adjustment previously made under the provisions of section 820 of the Revenue Act of 1938 or section 3801 of the Internal Revenue Code. In such cases, the tax previously determined will be the tax shown on the return, increased by the amounts previously assessed (or collected without assessment) as deficiencies, and decreased by amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax. If no amount was shown as the tax on the return, or if no return was made, the tax previously determined will be the sum of the amounts previously assessed (or collected without assessment) as deficiencies, decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax.

(*b*) After the tax previously determined has been ascertained, a recomputation must be made to ascertain the increase or decrease in tax represented by the difference, if any, between the tax previously determined and the tax as recomputed upon the basis of the correct treatment of the item or transaction.

With the exception of the items upon which the tax previously determined was based and the item or transaction with respect to which the erroneous treatment occurred, no item shall be considered in computing the amount of the increase or decrease in the tax previously determined. If the treatment of any item upon which the tax previously determined was based, or if the application of any provisions of the internal revenue laws with respect to such tax depends upon the amount of income (e. g., charitable contributions, foreign tax credit, earned income credit), readjustment of such items in conformity with the change in the amount of the income which results from the correct treatment of the item or transaction in respect of which the inconsistent position was adopted is necessary as part of the recomputation.

Example. In December, 1934, the X Corporation transferred depreciable property to the Y Corporation in exchange for stock of the Y Corporation having a fair market value of $100,000. Both corporations made their returns on the calendar year basis. At the time of the transfer, the property had an adjusted basis in the hands of the X Corporation of $80,000 and an estimated remaining life of 20 years. The exchange was treated as nontaxable and the gain of $20,000 realized by the X Corporation was not recognized. For each of the years 1935 to 1939, inclusive, the Y Corporation was allowed a deduction for depreciation in the amount of $4,000, computed on a basis of $80,000, the same basis the property had in the hands of the X Corporation. In its excess profits tax return for the taxable year 1940, the Y Corporation claimed that the property should have a basis of $100,000 for invested capital purposes, and also claimed a deduction of $5,000 for depreciation for such year. This position was based upon the contention that the 1934 exchange was taxable and the gain of $20,000 should have been recognized and added to the basis of the property in the hands of the Y Corporation. Timely claims for refund based upon the allowance of additional deductions for depreciation for the taxable years 1938 and 1939 were filed. The statute of limitations prevents any refund of overpayments or assessment of deficiencies for the taxable years 1934 to 1937, inclusive. The Commissioner's determination of the excess profits tax liability for the taxable year 1940 adopts the inconsistent position asserted by the Y Corporation and, accordingly, if the computation under section 734(d) discloses a net increase in the taxes previously determined for the taxable years for which correction is prevented, an adjustment is authorized under the provisions of section 734.

The X Corporation was not subject to the income tax imposed by Title IA of the Revenue Act of 1934. Its tax previously determined for the taxable year 1934 is $4,125, computed upon an income of $30,000. The corporation omitted from its gross income an item of rental income amounting to $3,000 and neglected to take a deduction for interest amounting to $1,500. During the taxable year it

sustained a capital loss of $10,000, of which amount only $2,000 was allowed as a deduction in computing its net income.

The increase in the tax of the X Corporation previously determined for 1934, plus the interest thereon, is computed as follows:

Tax previously determined for 1934		$4,125
Net income for 1934 upon which tax previously determined was based		30,000
Plus: Gain realized upon exchange	$20,000	
Less: Increased deduction for capital loss ($10,000 minus $2,000)	8,000	
		12,000
Net income as recomputed		42,000
Tax as recomputed		5,775
Tax previously determined		4,125
Increase in tax previously determined for 1934		1,650
Interest on increase in tax		594
Total increase for 1934		2,244

In accordance with the provisions of section 734(d), the recomputation does not take into consideration the item of $3,000, representing rental income which was omitted from gross income, or the item of $1,500, representing interest paid, for which no deduction was allowed.

The Y Corporation was not subject to the income tax imposed by Title IA of the Revenue Acts of 1934 or 1936. The decrease in the tax of the Y Corporation previously determined for each of the taxable years 1935, 1936, and 1937, which results solely from the allowance of an additional deduction of $1,000 for depreciation in each of such years, plus the interest on each such decrease, is assumed to be as follows:

Year.	Tax.	Interest.	Total.
1935	$137.50	$41.25	$178.75
1936	220.00	52.80	272.80
1937	220.00	39.60	259.60

The amount of the adjustment to be added to the excess profits tax of the Y Corporation otherwise determined for the taxable year 1940 is as follows:

Increase for 1934		$2,244.00
Less: Decrease for 1935	$178.75	
Decrease for 1936	272.80	
Decrease for 1937	259.60	
		711.15
Net increase (amount of adjustment authorized)		1,532.85

PAR. 32. The following is inserted immediately preceding section 30.740–1:

SEC. 8. INCORPORATION OF PARTNERSHIP OR SOLE PROPRIETORSHIP. (Excess Profits Tax Amendments of 1941.)

(a) Section 740(a)(1)(C) of the Internal Revenue Code is amended by striking out "owned by such other corporation." and inserting in lieu thereof:

"owned by such other corporation, or

"(D) Substantially all the properties of a partnership in an exchange to which section 112(b)(5), or so much of section 112(c) or (e) as refers to section 112(b)(5), or to which a corresponding provision of a prior revenue law, is or was applicable."

(b) Section 740(b)(4) of the Internal Revenue Code is amended by striking out the period at the end thereof and inserting in lieu thereof a semicolon and the following:

"or

"(5) In the case of a transaction specified in subsection (a)(1)(D), the partnership whose properties were acquired."

(c) Section 740 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsection:

"(h) SOLE PROPRIETORSHIP.—For the purposes of sections 740(a)(1)(D), 740(b)(5), and 742(g), a business owned by a sole proprietorship shall be considered a partnership."

* * * * * * *

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

PAR. 33. Section 30.740–1 is amended as follows:

(A) The word "elect" occurring in the second sentence is changed to "use."

(B) The third and fourth sentences of subsection (*a*) are amended to read as follows:

An acquiring corporation is a domestic corporation which has absorbed one or more other domestic corporations, partnerships, or businesses owned by sole proprietorships in a transaction meeting the requirements set forth in section 740(a). Each such absorbed corporation, partnership, or business owned by a sole proprietorship is designated a component corporation of the acquiring corporation.

(C) The last sentence of subsection (*a*) is amended to read as follows:

A foreign corporation can not be an acquiring corporation and neither a foreign corporation, a foreign partnership, nor a business owned by a foreign sole proprietorship can be a component corporation (see section 744).

(D) Subsection (*b*) is amended to read as follows:

(*b*) The purpose of Supplement A is in general to attribute to an acquiring corporation the existence of corporations, partnerships, or businesses owned by sole proprietorships absorbed by it, together with the base period excess profits net income or deficit in excess profits net income and the net capital changes of such predecessors, in order (1) that a corporation the corporate life of which in substance, though not in form, includes the base period may use the excess profits credit based on income and (2) that a corporation composed in whole or in part of qualified component corporations may compute its excess profits credit in the light of the base period experience of the entire enterprise. Accordingly, an acquiring corporation which was not actually in existence prior to January 1, 1940, is, notwithstanding section 712(a), nevertheless given the right to use the excess profits credit based on income, provided that it has a qualified component corporation. Furthermore, every acquiring corporation which is entitled to the excess profits credit based on income is required, if it was not actually in existence prior to January 1, 1940, and in every other case may elect, to take the base period experience of all qualified component corporations into account in computing its average base period net income. Finally, an acquiring corporation is required to add to its daily capital addition or reduction the net capital addition or reduction of each component corporation.

PAR. 34. Section 30.740–2 is amended as follows:

(A) By inserting immediately preceding the last paragraph thereof the following new paragraph:

(4) The acquisition of substantially all the properties of a partnership in an exchange to which section 112(b)(5), or so much of section 112 (c) or (e) as refers to section 112(b)(5), or to which the corresponding provisions of a

prior revenue law, is or was applicable. For the purposes of this paragraph a business owned by a sole proprietorship shall be considered a partnership.

(B) The last paragraph is amended to read as follows:

The types of transactions set forth in section 740(a), other than those set forth in section 740(a)(1)(C), either are embraced within the definition of a reorganization contained in section 112(g)(1), are transfers to a controlled corporation within the meaning of section 112(b)(5) and related sections, or are complete liquidations within the meaning of section 112(b)(6). Since Supplement A applies only to cases where there is a sufficient continuity of interest to justify treating a corporation by which the assets of another corporation, a partnership, or a business owned by a sole proprietorship have been acquired, as standing in the place of its predecessor, such transactions must satisfy all the requirements of the regulations prescribed under section 112 with respect to such transactions in order that the transferee corporation may be treated as an acquiring corporation.

PAR. 35. The following is inserted immediately following section 30.740–3:

SEC. 30.740–4. *Partnership as qualified component corporation.*—A partnership (or a business owned by a sole proprietorship) can not be an acquiring corporation and, therefore, section 740(g) can not operate to make any of its predecessors component corporations of its acquiring corporation. In order that a partnership (or a business owned by a sole proprietorship) may be a qualified component corporation it must have been actually in existence at the beginning of the taxpayer's base period. It is not sufficient that such partnership (or business owned by a sole proprietorship) has a predecessor which was in existence at such time.

PAR. 36. The following is inserted immediately preceding section 30.741–1:

SEC. 14. EXCESS PROFITS CREDIT OF ACQUIRING CORPORATIONS. (Excess Profits Tax Amendments of 1941.)

Section 741 of the Internal Revenue Code is amended to read as follows:

"SEC. 741. ALLOWANCE OF EXCESS PROFITS CREDIT.

"(a) ALLOWANCE.—In the case of a taxpayer which is an acquiring corporation which was in existence on the date of the beginning of its base period, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed.

"(b) EFFECT OF DISCLAIMER OF CREDIT.—If the taxpayer states in its return for the taxable year under this subchapter that it disclaims the use of the credit computed under section 713 or the use of the credit computed under section 714, the credit so disclaimed shall not, for the purposes of the internal revenue laws, be applicable to the computation of the tax under this subchapter for such taxable year."

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

PAR. 37. Section 30.741–1 is amended to read as follows:

SEC. 30.741–1. *Excess profits credit of acquiring corporations.*—Like any other domestic corporation, an acquiring corporation which was actually in existence prior to January 1, 1940, is entitled under section 712(a) to the excess profits credit based on income, computed under section 713, or the excess profits credit based on invested capital, computed under section 714, whichever credit results in the lesser tax for the taxable year for which the tax is being computed. Whether or not an acquiring corporation was actually in existence prior to January 1, 1940, however, any such corporation which was constructively in existence at the beginning of its 48-month base period by virtue of having acquired a qualified component corporation is entitled under section 741 to the excess profits credit based on income or the excess profits credit based on invested capital, whichever credit results in the lesser tax for the taxable year.

Every other acquiring corporation is entitled to use only the excess profits credit based on invested capital.

If an acquiring corporation which is entitled to whichever credit results in the lesser tax disclaims in its return for a particular taxable year the use of either credit, the credit so disclaimed shall not, for the purposes of the internal revenue laws, be applicable to the computation of the tax for the taxable year with respect to which the disclaimer is made. See section 729(b)(1).

PAR. 38. The following is inserted immediately preceding section 30.742–1:

SEC. 8. INCORPORATION OF PARTNERSHIP OR SOLE PROPRIETORSHIP. (Excess Profits Tax Amendments of 1941.)

* * * * * * *

(d) Section 742 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsection:

"(g) In the case of a partnership which is a component corporation by virtue of section 740(b)(5), the computations required by this Supplement shall be made, under rules and regulations prescribed by the Commissioner with the approval of the Secretary, as if such partnership had been a corporation. For the purpose of such computations, in making the adjustment for income taxes required by section 711(b)(1)(A), the partnership so regarded as a corporation shall be considered as having distributed all its net income as a dividend."

SEC. 15. AVERAGE BASE PERIOD NET INCOME OF ACQUIRING CORPORATIONS. (Excess Profits Tax Amendments of 1941.)

So much of section 742 of the Internal Revenue Code as follows the section heading and precedes the beginning of subsection (a) is amended to read as follows:

"In the case of a taxpayer which is an acquiring corporation the excess profits credit of which is allowed under section 741, its average base period net income (for the purpose of the credit computed under section 713) if the taxpayer was actually in existence before January 1, 1940, shall, at the election of the taxpayer made in its return for the taxable year, be computed as follows, and if the taxpayer was not actually in existence before such date, shall be computed as follows, in lieu of the method provided in section 713:".

SEC. 17. EFFECTIVE DATE. (Excess Profits Tax Amendments of 1941.)

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

PAR. 39. Section 30.742–1 is amended as follows:

(A) Wherever occurring therein, the term "net loss" is changed to "deficit in excess profits net income," and the term "net losses" is changed to "deficits in excess profits net income."

(B) The following is substituted for the first two sentences in subsection (*a*):

In computing the excess profits credit based on income, an acquiring corporation which was actually in existence prior to January 1, 1940, may, at its election, use as its average base period net income the average base period net income computed under section 742 with reference to the base period experience of the taxpayer and each qualified component corporation. If it fails so to elect, its average base period net income shall be the average base period net income computed under section 713 solely with reference to the taxpayer's own base period experience and without reference to the base period experience of any of the taxpayer's component corporations. The election shall be made in the excess profits tax return for the particular taxable year. An election once made is irrevocable for a particular taxable year, but a new election is granted for each succeeding taxable year.

An acquiring corporation which was not actually in existence prior to January 1, 1940, but which is entitled under section 741 to use the excess profits credit based on income, because of having been constructively in existence at the beginning of its base period, is required in every case to compute its average base period net income under section 742.

The following three steps are necessary in computing the average base period net income under section 742:

(C) Subsection (*b*) is amended by adding at the end thereof a new paragraph reading as follows:

In the case of a qualified component corporation which is a partnership or a business owned by a sole proprietorship, its excess profits net income or deficit in excess profits net income for each taxable year in the base period shall be determined as though such partnership or business owned by a sole proprietorship had been a corporation for each such year. Among the adjustments which will be necessary in computing the excess profits net income or deficit in excess profits net income are the following:

(1) A reasonable deduction for salary or compensation to each partner or the sole proprietor for personal services actually rendered shall be allowed;

(2) The credit for dividends received provided by section 26(b) and section 711(b)(1)(G) shall be allowed;

(3) The treatment of capital gains and losses shall be that applicable to corporations;

(4) The deduction for charitable contributions shall be that allowed by section 23(q);

(5) The income taxes allowed as a deduction either under section 711(b)(1)(A) or under section 23(c) shall be computed as though the partnership or business owned by a sole proprietor were a corporation and in computing such taxes the partnership or business owned by a sole proprietorship shall be deemed to have distributed all its net income as a dividend.

(D) The reference to "section 711(a)(1)(F)" occurring in subsection (c)(2)(iv) is changed to "section 711(b)(1)(G)."

PAR. 40. The following is inserted immediately preceding section 30.743–1:

SEC. 4. COMPUTATION OF AVERAGE BASE PERIOD NET INCOME. (Excess Profits Tax Amendments of 1941.)

* * * * * * *

(d) Section 743(a) of the Internal Revenue Code is amended by striking out "section 713(c)" and inserting in lieu thereof "section 713(g)."

PAR. 41. Section 30.743–1 is amended by inserting after the second paragraph thereof the following new paragraph:

The net capital addition or reduction of a partnership (or business owned by a sole proprietorship) which is a component corporation shall be determined as nearly as may be in the same manner as though such partnership (or business owned by a sole proprietorship) were a corporation. See section 742(g).

PAR. 42. Section 30.752–8 is amended by changing "83" appearing in item (8) of the example in subsection (*b*) to "183."

PAR. 43. Treasury Decision 5043, approved March 15, 1941 [page 479, this Bulletin] [sections 30.1 to 30.4, Title 26, Code of Federal Regulations, 1941 Sup.] is hereby superseded.

(This Treasury decision is issued under the authority contained in section 62 of the Internal Revenue Code (53 Stat., 32; 26 U. S. C., Sup. V, 62) and the Excess Profits Tax Amendments of 1941 (Public law 10, Seventy-seventh Congress).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved May 3, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register May 5, 1941, 3.24 p. m.)

EXCESS PROFITS TAX REGULATIONS [109].

1941–6–10595
T. D. 5037

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 30.

Regulations prescribed under the Excess Profits Tax Act of 1940 (Subchapter E of Chapter 2 of the Internal Revenue Code as added by the Second Revenue Act of 1940).*

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

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* Sections 30.0 to 30.752–8 issued under the authority contained in section 62 of the Internal Revenue Code (53 Stat., 32), as made applicable by section 729 of the Internal Revenue Code, added by the Second Revenue Act of 1940 (Public, No. 801, Seventy-sixth Congress, third session), and the statutory provisions which they follow.

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TITLE II—EXCESS PROFITS TAX (SECOND REVENUE ACT OF 1940).

SEC. 201. EXCESS PROFITS TAX OF 1940.

The Internal Revenue Code is amended by inserting after section 706 the following new subchapter which may be cited as the "Excess Profits Tax Act of 1940":

"SUBCHAPTER E—EXCESS PROFITS TAX.

"PART I.

* * * * * * *

"SEC. 728. MEANING OF TERMS USED.

"The terms used in this subchapter shall have the same meaning as when used in Chapter 1.

"SEC. 729. LAWS APPLICABLE.

"(a) GENERAL RULE.—All provisions of law (including penalties) applicable in respect of the taxes imposed by Chapter 1, shall, insofar as not inconsistent with this subchapter, be applicable in respect of the tax imposed by this subchapter.

* * * * * * *

SECTION 30.0. *Scope of regulations.*—These regulations deal with the excess profits tax imposed by the Excess Profits Tax Act of 1940 (Subchapter E of Chapter 2 of the Internal Revenue Code), which Act is referred to in these regulations as the "Act," and which tax is referred to in these regulations as the "excess profits tax." Such tax is to be distinguished from the excess-profits tax based on declared value capital stock imposed by Subchapter B of Chapter 2 of the Internal Revenue Code, referred to in these regulations as the "declared value excess-profits tax," and so designated by section 506 of the Second Revenue Act of 1940, which tax continues in effect and complements the capital stock tax.

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.

Each section of the regulations has been given a key number corresponding to the number of the section, subsection, or paragraph of the Internal Revenue Code which the regulations section interprets. Inasmuch as the regulations constitute Part 30 of Title 26 of the 1941 Supplement to the Code of Federal Regulations, each key number is preceded by the number 30 and a decimal point. The key number is followed by a dash (–) and the identifying number of the regulations section.

The regulations heretofore issued under section 725 relating to personal service corporations as paragraph 1 of Treasury Decision 5036, approved February 5, 1941 [page 276, this Bulletin], and the regulations heretofore issued under section 729 relating to the time and place for filing returns and the time for payment of the tax as Treasury Decision 5025, approved December 21, 1940 [C. B. 1940–2, 172], are hereby superseded.*

"SEC. 710. IMPOSITION OF TAX.

"(a) IMPOSITION.—There shall be levied, collected, and paid, for each taxable year beginning after December 31, 1939, on the adjusted excess profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax as follows:

"(1) Upon adjusted excess profits net incomes of less than $20,000, 25 per centum of the adjusted excess profits net income.

"$5,000 upon adjusted excess profits net incomes of $20,000; and upon adjusted excess profits net incomes in excess of $20,000, and not in excess of $50,000, 30 per centum in addition of such excess.

"$14,000 upon adjusted excess profits net incomes of $50,000; and upon adjusted excess profits net incomes in excess of $50,000, and not in excess of $100,000, 35 per centum in addition of such excess.

"$31,500 upon adjusted excess profits net incomes of $100,000; and upon adjusted excess profits net incomes in excess of $100,000, and not in excess of $250,000, 40 per centum in addition of such excess.

"$91,500 upon adjusted excess profits net income of $250,000; and upon adjusted excess profits net incomes in excess of $250,000, and not in excess of $500,000, 45 per centum in addition of such excess.

"$204,000 upon adjusted excess profits net incomes of $500,000; and upon adjusted excess profits net incomes in excess of $500,000, 50 per centum in addition of such excess.

"(2) APPLICATION OF RATES IN CASE OF CERTAIN EXCHANGES.—If the taxpayer's highest bracket amount for the taxable year computed under section 752 (relating to certain exchanges) is less than $500,000, then in the application of paragraph (1) of this subsection to such taxpayer, in lieu of each amount, other than the percentages, specified in such paragraph, there shall be

substituted an amount which bears the same ratio to the amount so specified as the highest bracket amount so computed bears to $500,000.

"(b) DEFINITION OF ADJUSTED EXCESS PROFITS NET INCOME.—As used in this section, the term 'adjusted excess profits net income' in the case of any taxable year means the excess profits net income (as defined in section 711) minus the sum of:

"(1) SPECIFIC EXEMPTION.—A specific exemption of $5,000;

"(2) EXCESS PROFITS CREDIT.—The amount of the excess profits credit allowed under section 712; and

"(3) UNUSED EXCESS PROFITS CREDIT.—In the case of a taxpayer the normal-tax net income of which for the taxable year is not more than $25,000, the amount by which the excess profits credit for the preceding taxable year (if beginning after December 31, 1939) exceeds the excess profits net income for such preceding taxable year."

SEC. 30.710–1. *Scope of tax.*—The excess profits tax is imposed upon the adjusted excess profits net income of every corporation, both domestic and foreign, for each income-tax taxable year beginning after December 31, 1939, except certain corporations which are exempt. (See section 727.) A corporation the excess profits net income of which, computed as provided in section 711 (a) (2) and (3), is not greater than $5,000 need not file an excess profits tax return. (See section 729 (b).) A personal service corporation, as defined in section 725, may elect not to be subject to the excess profits tax, thereby making its income taxable to its shareholders as provided in Supplement S of Chapter 1 of the Internal Revenue Code. (See section 725.)*

SEC. 30.710–2. *Measure and rate of tax.*—The tax is based on the adjusted excess profits net income for the taxable year. The adjusted excess profits net income is determined by deducting from the excess profits net income (determined as provided in section 711) the sum of:

A specific exemption of $5,000,

The excess profits credit allowed by section 712, or section 741 in the case of certain reorganizations, and

A carry-over, in certain cases, of the unused excess profits credit of the preceding taxable year.

The unused excess profits credit carry-over consists of the amount by which the excess profits credit for the preceding taxable year exceeds the excess profits net income for such preceding taxable year, and is available only if the preceding taxable year began after December 31, 1939, and if the normal-tax net income of the corporation for the current taxable year does not exceed $25,000.

As to the exemption of income derived from certain mining operations, see section 731, and as to the excess profits tax of corporations completing contracts under the Merchant Marine Act of 1936, see section 726.

The following table shows the excess profits tax due for taxable years beginning after December 31, 1939, upon certain specified amounts of adjusted excess profits net income. In each instance the first figure of the adjusted excess profits net income in the adjusted excess profits 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 adjusted excess profits net income column. The last column gives the total excess profits tax on an adjusted excess profits net income equal to the second figure in the excess profits net income column.

EXCESS PROFITS TAX TABLE.

Adjusted excess profits net income.	Per cent.	Total excess profits tax.
$0 to $20,000	25	$5,000
$20,000 to $50,000	30	14,000
$50,000 to $100,000	35	31,500
$100,000 to $250,000	40	91,500
$250,000 to $500,000	45	204,000
$500,000 up	50	

The excess profits tax for any amount of adjusted excess profits net income ıt stated in round figures in the table is computed by adding to the excess ofits tax for the largest amount stated which is less than the adjusted excess ofits net income, the excess profits tax upon the excess over that amount at e rate indicated in the table.

The computation of the tax is illustrated by the following example:

Example: The X Corporation has for the calendar year 1940 an excess profits ıt income of $800,000. The amount of its excess profits credit as allowed under ction 712 is $195,000. The excess profits tax of the corporation for the calendar year 1940 is $254,000, computed as follows:

ıcess profits net income		$800,000
ıss:		
Specific exemption	$5,000	
Excess profits credit	195,000	
		200,000
ljusted excess profits net income		600,000
ɔmputation of excess profits tax:		
Tax on $500,000 (see table)		204,000
Tax on $100,000 at 50 per cent		50,000
Total		254,000

Adjustments are required in the above excess profits tax table in the case of rporations which have been through certain tax-free exchanges or liquidations ıfter December 31, 1939) described in sections 750 and 752 and which, as a nsequence, have a highest bracket amount of less than $500,000. For defini-ɔn and computation of highest bracket amount see sections 750(e) and 752. ıch adjustment is accomplished by applying to such table the ratio of the ·rporation's highest bracket amount, adjusted as provided in section 752, to ıat its highest bracket amount would have been if the adjustments required ' section 752 had not been made, that is, $500,000. Thus, if the highest ·acket amount of a corporation as computed under section 752 is only $300,000, ıe dollar amounts in the table applicable to such corporation will be only $\frac{0,000}{0,000}$, or 60 per cent, of the amounts therein set forth. The left-hand column ıeaded "Adjusted Excess Profits Net Income") of the table applicable to ıch a corporation would therefore read $0 to $12,000, $12,000 to $30,000, ;0,000 to $60,000, $60,000 to $150,000, $150,000 to $300,000, and $300,000 up. he right-hand column (headed "Total Excess Profits Tax") would read ,000, $8,400, $18,900, $54,900, and $122,400. The middle, or percentage, column ould remain unchanged.

The table as so revised would be applicable whether the corporation's excess ofits credit is based on income or invested capital. If, after the adjustments ·ovided by section 752, the highest bracket amount of a corporation is still 00,000, no adjustment in the table is necessary, since the ratio of the highest acket amount to $500,000 will produce a percentage of 100. The highest acket amount of a corporation can never exceed $500,000, and therefore any ljustment in the table required by section 710(a)(2) will operate to reduce e dollar amounts appearing therein and thus to increase the total tax.

If the facts relative to the X Corporation were the same as assumed in the eceding example in this section except that the X Corporation has a highest acket amount of only $300,000 instead of $500,000, the excess profits tax of ch corporation for the calendar year 1940 would be $272,400, computed as llows:

ɔmputation of excess profits tax:		
Tax on $300,000 from table as revised		$122,400
Tax on $300,000 at 50 per cent		150,000
Total		272,400

If the highest bracket amount of a corporation were an amount other than 00,000, and less than $500,000, the revision of the excess profits tax table ɔuld be correspondingly different. For example, if the highest bracket amount ere $200,000, the adjusted figures would be 40 per cent, in lieu of 60 per cent, the dollar amounts set forth in the table.

For computation of tax for periods of less than 12 months, see section 711(a)(3).*

"SEC. 711. EXCESS PROFITS NET INCOME.

"(a) TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1939.—The excess profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13(a)(2), for such year except that the following adjustments shall be made:

"(1) EXCESS PROFITS CREDIT COMPUTED UNDER INCOME CREDIT.—If the excess profits credit is computed under section 713, the adjustments shall be as follows:

"(A) Income Taxes.—The deduction for taxes shall be increased by an amount equal to the tax (not including the tax under section 102) under Chapter 1 for such taxable year;

"(B) Long-Term Gains and Losses.—There shall be excluded long-term capital gains and losses. There shall be excluded the excess of gains from the sale or exchange of property held for more than eighteen months which is of a character which is subject to the allowance for depreciation provided in section 23(l) over the losses from the sale or exchange of such property;

"(C) Income From Retirement or Discharge of Bonds, and So Forth.—There shall be excluded, in the case of any taxpayer, income derived from the retirement or discharge by the taxpayer of any bond, debenture, note, or certificate or other evidence of indebtedness, if the obligation of the taxpayer has been outstanding for more than eighteen months, including, in case the issuance was at a premium, the amount includible in income for such year solely because of such retirement or discharge;

"(D) Refunds and Interest on Agricultural Adjustment Act Taxes.—There shall be excluded income attributable to refund of tax paid under the Agricultural Adjustment Act of 1933, as amended, and interest upon any such refund;

"(E) Recoveries of Bad Debts.—There shall be excluded income attributable to the recovery of a bad debt if a deduction with reference to such debt was allowable from gross income for any taxable year beginning prior to January 1, 1940;

"(F) Dividends Received.—The credit for dividends received shall apply, without limitation, to dividends on stock of domestic corporations.

"(2) EXCESS PROFITS CREDIT COMPUTED UNDER INVESTED CAPITAL CREDIT.—If the excess profits credit is computed under section 714, the adjustments shall be as follows:

"(A) Dividends Received.—The credit for dividends received shall apply, without limitation, to all dividends on stock of all corporations, except dividends (actual or constructive) on stock of foreign personal-holding companies;

"(B) Interest.—The deduction for interest shall be reduced by an amount equal to 50 per centum of so much of such interest as represents interest on the indebtedness included in the daily amounts of borrowed capital (determined under section 719(a));

"(C) Income Taxes.—The deduction for taxes shall be increased by an amount equal to the tax (not including the tax under section 102) under Chapter 1 for such taxable year;

"(D) Long-Term Gains and Losses.—There shall be excluded long-term capital gains and losses. There shall be excluded the excess of gains from the sale or exchange of property held for more than eighteen months which is of a character which is subject to the allowance for depreciation provided in section 23(l) over the losses from the sale or exchange of such property;

"(E) Income From Retirement or Discharge of Bonds, and So Forth.—There shall be excluded, in the case of any taxpayer,

income derived from the retirement or discharge by the taxpayer of any bond, debenture, note, or certificate or other evidence of indebtedness, if the obligation of the taxpayer has been outstanding for more than eighteen months, including, in case the issuance was at a premium, the amount includible in income for such year solely because of such retirement or discharge;

"(F) Refunds and Interest on Agricultural Adjustment Act Taxes.—There shall be excluded income attributable to refund of tax paid under the Agricultural Adjustment Act of 1933, as amended, and interest upon any such refund;

"(G) Interest on Certain Government Obligations.—The normal-tax net income shall be increased by an amount equal to the amount of the interest on obligations held during the taxable year which are described in section 22(b)(4) any part of the interest from which is excludible from gross income or allowable as a credit against net income, if the taxpayer has so elected under section 720(d); and

"(H) Recoveries of Bad Debts.—There shall be excluded income attributable to the recovery of a bad debt if a deduction with reference to such debt was allowable from gross income for any taxable year beginning prior to January 1, 1940.

"(3) TAXABLE YEAR LESS THAN TWELVE MONTHS.—If the taxable year is a period of less than twelve months the excess profits net income shall be placed on an annual basis by multiplying the amount thereof by the number of days in the twelve months ending with the close of the taxable year and dividing by the number of days in the taxable year. The tax shall be such part of the tax computed on such annual basis as the number of days in the taxable year is of the number of days in the twelve months ending with the close of the taxable year.

* * * * * *

SEC. 30.711(a)-1. *Excess profits net income for the taxable year.*—Two ethods are provided for determining the excess profits net income for the xable year. One method, that provided by section 711(a)(1), is to be used if e excess profits credit is computed under section 713, which credit is referred to these regulations as the income credit. The other method, that provided by ction 711(a)(2), is to be used if the excess profits credit is computed under ction 714, which credit is referred to in these regulations as the invested capital edit. As to corporations having the option to elect as between the income edit and the invested capital credit, and corporations required to use the vested capital credit, see sections 712 and 741. The normal-tax net income r the taxable year as defined in section 13(a)(2) must first be ascertained ider either method. The normal-tax net income may be a minus quantity r the purpose of section 711 if and to the extent not attributable to a t operating loss deduction. The normal-tax net income having been deterined, certain adjustments must be made as provided in section 711(a) (1) or), whichever is applicable.*

SEC. 30.711(a)-2. *Excess profits net income if income credit is used.*—If the cess profits credit for the taxable year is computed under section 713, the rmal-tax net income for such year shall be adjusted as provided in section 1(a)(1).

In making the adjustment provided in section 711(a)(1)(A), the amount r which the deduction for taxes is to be increased is an amount equal to the x for the taxable year under Chapter 1 (not including the tax imposed ider section 102) after the allowance of the credit for foreign taxes as ovided in sections 31 and 131.

In making the adjustment provided in section 711(a)(1)(C), the term indebtedness" as used therein includes indebtedness assumed by the taxyer even though such indebtedness is evidenced, so far as the taxpayer is ncerned, only by a contract (which has been outstanding for more than 18 onths) with the person whose liabilities have been assumed. Also, a rewal obligation is to be considered to be outstanding for more than 18 onths if the original obligations and the renewal obligations taken together ve been outstanding for a total of more than 18 months. The term "other idence of indebtedness" does not include open account book entries.

The refunds of Agricultural Adjustment Act taxes referred to in sectio 711(a)(1)(D) include only those made under Title VII of the Revenue Act o 1936 and refunds made to processors under section 15(a) of the Agricultura Adjustment Act as reenacted by section 601 of the Revenue Act of 1936.

The provisions of section 711(a)(1)(E), relating to recoveries of bad debts are not applicable in the case of a taxpayer using the reserve method o treating bad debts as provided in sections 19.23(k)-1 and 19.23(k)-5 of Regu lations 103.

The computation of the excess profits net income in the cases where the incom credit is used may be illustrated by the following example:

Example: The facts with respect to the X Corporation for the calendar yea 1940 are as follows:

(1) The normal-tax net income of the corporation is $400,000.

(2) The tax of the corporation under Chapter 1 (excluding any ta liability under section 102 and after credit for foreign tax) is $83,000.

(3) The corporation has long-term capital gains of $100,000 and long terms capital losses of $75,000. It has gains of $50,000 and losses o $100,000 from sales of property held for more than 18 months and of character subject to the allowance for depreciation provided in sectio 23(1).

(4) On January 1, 1930, the corporation issued at a premium of $40,00 bonds with a total face value of $800,000, maturing December 31, 194 On January 1, 1940, the corporation purchases one-half of the amount o the bonds for $390,000. For the years 1930 to 1939, inclusive, it ha returned $10,000 as income with respect to the premium on the bond it so purchased. The corporation has never been in an unsound financia condition.

(5) The corporation derives income in the amount of $400 attributabl to refund of tax paid under the Agricultural Adjustment Act of 1933, a amended, and interest upon such refund.

(6) For the calendar year 1935, the corporation deducted $10,000 as bad debt, which deduction was allowable. During the calendar year 194 it recovers $5,000 with respect to such debt.

(7) The corporation receives as dividends: $100,000 of the class wit respect to which a credit is allowed by section 26(b), $20,000 from China Trade Act corporation, and $20,000 from a foreign corporation whic is not a foreign personal-holding company.

If the income credit is used, the excess profits net income of the corpora tion for the calendar year 1940 is $231,600, computed as follows:

Normal-tax net income		$400,00
Plus:		
Long-term capital losses		75,00
		475,00
Less:		
Income tax under Chapter 1	$83,000	
Long-term capital gains	100,000	
Income from retirement of bonds	20,000	
Income from refunds of Agricultural Adjustment Act taxes and interest thereon	400	
Income from recovery of bad debts	5,000	
Additional dividends received credit (100 per cent of total dividends of $120,000 received from domestic corporations including the China Trade Act corporation, less credit of $85,000 already allowed by section 26(b) for dividends received, or $120,000 minus $85,000)	35,000	
		243,40
Excess profits net income		231,60

It is to be observed that no adjustment under section 711(a)(1)(B) is require to be made for the gains and losses from the sale of property held for mo than 18 months which is of a character subject to allowances for depreciatio since such losses exceed such gains. It is also to be observed that no adjus

nent under section 711(a)(1)(F) is required to be made for the $20,000 dividends received from the foreign corporation.*

SEC. 30.711(a)-3. *Excess profits net income if invested capital credit is used.*—If the excess profits credit for the taxable year is computed under section 714, the normal-tax net income for such year shall be adjusted as provided in section 711(a)(2). Such adjustments are the same as the adjustments provided in section 711(a)(1) except that the following additional adjustments are required to be made:

(*a*) There shall be added to the normal-tax net income:

(1) An amount equal to 50 per cent of the deduction for interest on the indebtedness included in the daily amounts of borrowed capital (determined under section 719(a)); and

(2) An amount equal to the amount of interest on obligations held during the taxable year which are described in section 22(b)(4), any part of the interest from which is excludible from gross income or allowable as a credit against net income, if the corporation has elected under section 720(d) to treat such interest as taxable for excess profits tax purposes. As used in paragraph (2), the term "interest" includes, in the case of obligations issued at a discount, so much of such discount as (for purposes of determining gain or loss upon sale or other disposition) is treated as interest in the hands of the taxpayer for the taxable year.

(*b*) There shall be subtracted from the normal-tax net income the amount of dividends received from foreign corporations, except dividends (actual or constructive) on stock of foreign personal holding companies.

The computation of the excess profits net income in cases where the invested capital credit is used may be illustrated by the following example:

Example: The facts present in the example in section 30.711(a)-2 with respect to the X Corporation are also present with respect to the Y Corporation, and in addition the following facts are present with respect to the latter corporation:

(*a*) During the calendar year 1940 the corporation pays interest amounting to $48,000 on the bonds referred to in (4) of that example.

(*b*) Throughout the entire calendar year 1940 the corporation owns $100,000 of Treasury bonds 1944–54 and $100,000 of bonds issued by a State. It derives income for the year 1940 from interest on such bonds amounting to $6,000. The corporation elects under section 720(d) to increase its normal-tax net income for excess profits tax purposes for the year 1940 by an amount equal to the amount of interest on all obligations held during that year which are described in section 22(b)(4).

If the invested capital credit is used, the excess profits net income of the corporation for the calendar year 1940 is $241,600, computed as follows:

Normal-tax net income		$400,000
Plus:		
Long-term capital losses	$75,000	
50 per cent of interest on indebtedness included in borrowed capital	24,000	
Interest on Government and State obligations	6,000	
		105,000
		505,000
Less:		
Income tax under Chapter 1	$83,000	
Long-term capital gains	100,000	
Income from retirement of bonds	20,000	
Income from refunds of Agricultural Adjustment Act taxes and interest thereon	400	
Income from recovery of bad debts	5,000	
Additional dividends received credit ($140,000 dividends received from both domestic and foreign corporations less credit of $85,000 already allowed by section 26(b) for dividends received)	55,000	
		263,400
Excess profits net income under section 711(a)(2)		241,600

*

SEC. 30.711(a)-4. *Tax for period of less than 12 months.*—Sections 711(a)(3) provides that if the taxable year is a period of less than 12 months the excess profits net income shall be placed on an annual basis by multiplying the amount thereof by the number of days in the 12 months ending with the close of the taxable year and by dividing such product by the number of days in the taxable year. A tentative tax shall then be computed as though the excess profits net income were the amount so ascertained. The actual tax for the taxable year shall be an amount which bears the same ratio to such tentative tax as the number of days in the taxable year bears to the total number of days in the 12 months ending with the close of the taxable year. The first "taxable year" of a corporation which files a return of income received or accrued from the date of its incorporation to the end of its first accounting period is a period of less than 12 months, where the period between the date of incorporation and the end of such first accounting period is less than 12 months.*

"SEC. 711. EXCESS PROFITS NET INCOME.

* * * * * * *

"(b) TAXABLE YEARS IN BASE PERIOD.—

"(1) GENERAL RULE AND ADJUSTMENTS.—The excess profits net income for any taxable year subject to the Revenue Act of 1936 shall be the normal-tax net income, as defined in section 13(a) of such Act; and for any other taxable year beginning after December 31, 1937, and before January 1, 1940, shall be the special-class net income, as defined in section 14(a) of the applicable revenue law. In either case the following adjustments shall be made (for additional adjustments in case of certain reorganizations, see section 742(e)):

"(A) Income Taxes.—The deduction for taxes shall be increased by an amount equal to the tax (not including the tax under section 102) for such taxable year under Title I or Chapter 1, as the case may be, of the revenue law applicable to such year;

"(B) Long-Term Gains and Losses.—There shall be excluded long-term capital gains and losses. There shall be excluded the excess of gains from the sale or exchange of property held for more than eighteen months which is of a character which is subject to the allowance for depreciation provided in section 23(l) over the losses from the sale or exchange of such property;

"(C) Income from Retirement or Discharge of Bonds, and So Forth.—There shall be excluded, in the case of any taxpayer, income derived from the retirement or discharge by the taxpayer of any bond, debenture, note, or certificate or other evidence of indebtedness, if the obligation of the taxpayer has been outstanding for more than eighteen months, including, in case the issuance was at a premium, the amount includible in income for such year solely because of such retirement or discharge;

"(D) Deductions on Account of Retirement or Discharge of Bonds, and So Forth.—If during the taxable year the taxpayer retires or discharges any bond, debenture, note, or certificate or other evidence of indebtedness, if the obligation of the taxpayer has been outstanding for more than eighteen months, the following deductions for such taxable year shall not be allowed:

"(i) The deduction allowable under section 23(a) for expenses paid or incurred in connection with such retirement or discharge;

"(ii) The deduction for losses allowable by reason of such retirement or discharge; and

"(iii) In case the issuance was at a discount, the amount deductible for such year solely because of such retirement or discharge;

"(E) Casualty, Demolition, and Similar Losses.—Deductions under section 23(f) for losses arising from fires, storms, ship-

wreck, or other casualty, or from theft, or arising from the demolition, abandonment, or loss of useful value of property, not compensated for by insurance or otherwise, shall not be allowed;

"(F) Repayment of Processing Tax to Vendees.—The deduction under section 23(a), for any taxable year, for expenses shall be decreased by an amount which bears the same ratio to the amount deductible on account of any repayment or credit by the corporation to its vendee of any amount attributable to any tax under the Agricultural Adjustment Act of 1933, as amended, as the excess of the aggregate of the amounts so deductible in the base period over the aggregate of the amounts attributable to taxes under such Act collected from its vendees which were includible in the corporation's gross income in the base period and which were not paid, bears to the aggregate of the amounts so deductible in the base period;

"(G) Payment of Judgments, and So Forth.—Deductions attributable to any claim, award, judgment, or decree against the taxpayer, or interest on any of the foregoing, shall not be allowed if in the light of the taxpayer's business it was abnormal for the taxpayer to incur a liability of such character or, if the taxpayer normally incurred such liability, the amount of such liability in the taxable year was grossly disproportionate to the amount of such liability in the four previous taxable years;

"(H) All expenditures for intangible drilling and development costs paid or incurred in or for the drilling of wells or the preparation of wells for the production of oil or gas, or expenditures for development costs in the case of mines, which the taxpayer has deducted from gross income as an expense, shall not be allowed to the extent that in the light of the taxpayer's business it was abnormal for the taxpayer to incur a liability of such character or, if the taxpayer normally incurred such liability, to the extent that the amount of such liability in the taxable year was grossly disproportionate to the amount of such liability in the four previous taxable years; and

"(I) Dividends Received.—The credit for dividends received shall apply, without limitation, to dividends on stock of domestic corporation.

"(2) Capital gains and losses.—For the purposes of this subsection the normal-tax net income and the special-class net income referred to in paragraph (1) shall be computed as if section 23(g)(2), section 23(k)(2), and section 117 were part of the revenue law applicable to the taxable year the excess profits net income of which is being computed, with the exception that the net short-term capital loss carry-over provided in subsection (e) of section 117 shall be applicable to net short-term capital losses for taxable years beginning after December 31, 1934. Such exception shall not apply for the purposes of computing the tax under this subchapter for any taxable year beginning before January 1, 1941."

Sec. 30.711(b)-1. *Computation of excess profits net income for taxable years in base period.*—If the excess profits credit for the taxable year is computed under section 713, it is necessary to compute the excess profits net income for each taxable year of the base period. The taxable years in the base period are those beginning after December 31, 1935, and before January 1, 1940. For a taxable year beginning after December 31, 1935, and before January 1, 1938, the starting point in the determination of the excess profits net income is the normal-tax net income, as defined in section 13(a) of the Revenue Act of 1936. For a taxable year beginning after December 31, 1937, the starting point is the special-class net income, as defined in section 14(a) of the Revenue Act of 1938 and the Internal Revenue Code. The amount to be used is the correct normal-tax net income or special-class net income, as the case may be, regardless of the amount shown in the return for such year and regardless of the fact that the assessment of a deficiency or the allowance of a refund may be barred by the statute of limitations.

The normal-tax net income or the special-class net income, as the case may be, is to be adjusted first as required by section 711(b)(2) and then as required by section 711(b)(1).

The adjustments required by sections 711(b)(2) and 711(b)(1)(B) may be illustrated by the following example:

Example: The normal-tax net income of the X Corporation for the calendar year 1936 is $50,000 and its special-class net income for the calendar year 1939 is $200,000. In December, 1935, the corporation purchased shares of stock and bonds of other corporations for a total purchase price of $25,000. The corporations were never included in a consolidated return. Such shares of stock and bonds were capital assets. They became worthless in 1936 and the bonds were charged off during that year. In addition, the corporation had gains and losses as follows:

	1936	1939
Short-term capital gains	$12,000	None
Short-term capital losses (disregarding any carry-over)	26,000	None
Long-term capital gains	10,000	$25,000
Long-term capital losses	30,000	1,000
Net gain or net loss from the sales of property held for more than 18 months of the character subject to the allowance for depreciation provided in section 23(l)	−5,000	+3,000

The adjustments required in computing the excess profits net income of the corporation for 1936 and 1939 are as follows:

1936		
Normal-tax net income		$50,000
Adjustment under section 711(b)(2):		
Add deductions for loss on worthless stock and bonds ($25,000) and for capital net loss ($2,000) ($25,000 plus $2,000 or $27,000)		27,000
		77,000
Subtract deduction for net long-term capital loss of $20,000 and for net loss of $5,000 from sales of property held for more than 18 months of the character subject to the allowance for depreciation provided in section 23(l)		25,000
Normal-tax net income adjusted as required by section 711(b)(2)[1]		52,000
Adjustments under section 711(b)(1)(B):		
Add net long-term capital loss of $20,000		20,000
Normal-tax net income adjusted as required by section 711(b)(2) and section 711(b)(1)(B)		72,000
1939		
Special-class net income		200,000
(No adjustment required under section 711(b)(2).)		
Adjustments under section 711(b)(1)(B):		
Deduct net long-term capital gain of $24,000 ($25,000—$1,000) and net gain of $3,000 from sales of property held for more than 18 months of the character subject to the allowance for depreciation as provided in section 23(l)		27,000
Special-class net income adjusted as required by sections 711(b)(2) and 711(b)(1)(B)		173,000

In making the adjustments required to be made by section 711(b)(1)(A) the amount of the income tax required to be deducted is the correct amount for the taxable year, regardless of the fact that the assessment or collection of any deficiency or the allowance of any refund may be barred by the statute of limitations.

[1] Since under section 117 of the Code, short-term capital losses are deductible only to the extent of short-term capital gains, the excess of short-term capital losses over short-term capital gains ($51,000 ($25,000 on account of worthless stock and bonds, plus $26,000 other short-term capital losses) minus $12,000, or $39,000) does not enter into the adjustment.

In making the adjustments provided in section 711(b)(1)(D), the deduction allowable for any premium paid on bonds when called for redemption shall be disallowed, but the deduction allowable for any discount amortized up to the date of retirement or discharge shall not be disallowed. Expenses incurred in issuing bonds which are amortized shall be treated in the same manner as discounts. The adjustments required by section 711(b)(1)(D) may be illustrated by the following example:

Example: The normal-tax net income of the M Corporation for the calendar year 1936 is $75,000. On January 1, 1935, the corporation issued 1,200 nonserial bonds with a total face value of $120,000 at a discount of $14,400, maturing on December 31, 1954. On August 1, 1936, the corporation purchased one-sixth of the amount of the bonds for $19,000. The deduction allowable under section 23(a) of the Revenue Act of 1936 for expenses paid in connection with such purchase amounted to $1,200. The adjustments required by section 711(b)(1)(D) in computing the excess profits net income of the corporation for 1936 are as follows:

Normal-tax net income		$75,000
Adjustment under section 711(b)(1)(D):		
Add:		
(i) Deduction allowable for expenses in connection with retirement	$1,200	
(ii) Deduction for losses allowable by reason of retirement	None	
(iii) Amount deductible because of retirement or discharge of bonds ($1,210 computed as in Schedule below)	1,210	
		2,410
Normal-tax net income adjusted as required by section 711(b)(1)(D)		77,410
Schedule—		
(*a*) Annual amortization on $14,400 discount ($14,400÷20)		720
(*b*) Annual amortization of discount on block of bonds retired ($720÷6)		120
(*c*) Monthly amortization of discount on block of bonds retired ($120÷12)		10
(*d*) Amortized discount deductible on block of bonds retired on August 1, 1936 ($10×19)		190
(*e*) Purchase price of bonds retired on August 1, 1936		19,000
(*f*) Issuing price of bonds retired on August 1, 1936 $\left(\frac{1,200\times\$88}{6}\right)$		17,600
(*g*) Total amount of discount deductible on account of retirement of bonds on August 1, 1936 ($19,000—$17,600)		1,400
(*h*) Amount deductible because of retirement or discharge of bonds (item (*g*) less item (*d*), or $1,400—$190)		1,210

The adjustments required by section 711(b)(1)(F) may be illustrated by the following example:

Example: The normal-tax net income of the O Corporation for the calendar year 1936 is $75,000. During that year the corporation collected from its vendees $2,000 attributable to taxes under the Agricultural Adjustment Act of 1933, as amended. The $2,000 was included in the gross income of the corporation for 1936 and the taxes to which such amount was attributable were not paid. During the years 1936 and 1937 the corporation repaid to its vendees $6,000 and $2,000, respectively, of amounts it had collected from them for 1936 and prior years attributable to such taxes. It made no such repayments during the years 1938 and 1939. The amount repaid to the vendees in 1936 is deductible from the corporation's gross income for that year. The adjustments required by section 711(b)(1)(F) in computing the excess profits net income of the corporation for 1936 are as follows:

Normal-tax net income	$75,000
Adjustment under section 711(b)(1)(F):	
Add: The amount of $4,500, computed as shown in the schedule below	4,500
Normal-tax net income adjusted as required by section 711(b)(1)(F)	79,500

Schedule—

(*a*) Amount deductible under section 23(a) for 1936 on account of repayment to vendees of amounts collected from vendees attributable to taxes under Agricultural Adjustment Act of 1933, as amended, which were not paid	$6,000
(*b*) Aggregate amounts described in (*a*) deductible in the base period ($6,000 plus $2,000)	$8,000
(*c*) Aggregate of amounts described in (*a*) collected from vendees and includible in gross income of corporation in base period	$2,000
(*d*) Excess of (*b*) over (*c*) ($8,000 minus $2,000)	$6,000
(*e*) Ratio of (*d*) to (*b*)	6/8
(*f*) Amount of adjustment $\left(\frac{(d)\times(a)}{(b)}, \text{or } \frac{6 \text{ of } \$6,000}{8}\right)$	$4,500

In connection with the adjustments required to be made by section 711(b)(1)(G) and (H), see the regulations under section 721 relating to claims, awards, judgments, or decrees, and to the determination of abnormality either in kind or in amount.*

" SEC. 712. EXCESS PROFITS CREDIT—ALLOWANCE.

"(a) DOMESTIC CORPORATIONS.—In the case of a domestic corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall, at the election of the taxpayer made in its return for such taxable year, be an amount computed under section 713 or section 714. (For election in case of certain reorganizations of corporations not qualified under the preceding sentence, see section 741.) In the case of all other domestic corporations the excess profits credit for any taxable year shall be an amount computed under section 714. In the case of a domestic corporation which for any taxable year does not file a return before the expiration of the time prescribed by law for filing such return, the excess profits credit for such taxable year shall be an amount computed under section 714.

"(b) FOREIGN CORPORATIONS.—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 first taxable year of which under this subchapter begins on any date in 1940, which was in existence on the day forty-eight months prior to such date and which at any time during each of the taxable years in such forty-eight months was engaged in trade or business within the United States or had an office or place of business therein, the excess profits credit for any taxable year shall, at the election of the taxpayer in its return for such taxable year be an amount computed under section 713 or section 714. In the case of all other such foreign corporations the excess profits credit for any taxable year shall be an amount computed under section 714. In the case of a foreign corporation which for any taxable year does not file a return before the expiration of the time prescribed by law for filing such return, the excess profits credit for such taxable year shall be an amount computed under section 714."

SEC. 30.712-1. *Excess profits credit—Allowance.*—(*a*) Two methods are provided for computing the excess profits credit: (1) The income method under which the credit is computed as provided in section 713, and (2) the invested capital method under which the credit is computed as provided in section 714.

(*b*) The following corporations are given the option to adopt either method:

(1) A domestic corporation which was in existence before January 1, 1940.

(2) A domestic corporation not in existence before January 1, 1940, but given the right to an election under section 741. (For computation of excess profits credit based on income in such cases, see sections 740 to 744.)

(3) A foreign corporation (i) which is engaged in trade or business within the United States or having an office or place of business therein at any time during the taxable year; (ii) the first taxable year of which for the purposes of the excess profits tax begins on any date in 1940; (iii) which was in existence on the day 48 months prior to such date; and (iv) which, at any time during each of the taxable years in such 48

months, was engaged in trade or business within the United States or had an office or place of business therein. As to what constitutes being engaged in trade or business within the United States, see section 19.231–1 of Regulations 103.

The election, which within the meaning of the Act must be unqualified, shall be made in the excess profits tax return for the particular taxable year, filed within the time prescribed by law. The election for that year once made is irrevocable after the expiration of such time, but a new election is granted for each succeeding taxable year. The time prescribed by law for filing the return includes the period of any extension of time granted by the Commissioner.

(*c*) The following corporations subject to the excess profits tax have no option and shall use the invested capital method provided in section 714:

(1) Any corporation, domestic or foreign, which fails to file a return for the taxable year within the statutory period for filing the return, or within such period as extended.

(2) All other domestic and foreign corporations not described in paragraph (*b*) of this section.*

" SEC. 713. EXCESS PROFITS CREDIT—BASED ON INCOME.

"(a) AMOUNT OF EXCESS PROFITS CREDIT.—The excess profits credit for any taxable year, computed under this section, shall be—

"(1) DOMESTIC CORPORATIONS.—In the case of a domestic corporation—

"(A) 95 per centum of the average base period net income, as defined in subsection (b),

"(B) Plus 8 per centum of the net capital addition as defined in subsection (c), or

"(C) Minus 6 per centum of the net capital reduction as defined in subsection (c).

"(2) FOREIGN CORPORATIONS.—In the case of a foreign corporation, 95 per centum of the average base period net income.

"(b) AVERAGE BASE PERIOD NET INCOME.—For the purposes of this section the average base period net income of the taxpayer shall be determined as follows:

"(1) By computing the aggregate of the excess profits net income for each of the taxable years of the taxpayer beginning after December 31, 1935, and before January 1, 1940, reduced, in the case of each such taxable year in which the deductions plus the credit for dividends received exceeded the gross income, by the amount attributable to such excess under paragraph (4);

"(2) By dividing the amount ascertained under paragraph (1) by the total number of months in all such taxable years; and

"(3) By multiplying the amount ascertained under paragraph (2) by twelve.

"(4) For the purposes of paragraph (1)—

"(A) In determining whether, for any taxable year, the deductions plus the credit for dividends received exceeded the gross income, and in determining the amount of such excess, the adjustments provided in section 711(b)(1) shall be made; and

"(B) The amount attributable to any taxable year in which there is such an excess shall be the amount of such excess, except that such amount shall be zero if there is only one such year, or, if more than one, shall be zero for the year in which such excess is the greatest.

"(5) For the purposes of paragraph (1), if the taxpayer was in existence during only part of the 48 months preceding the beginning of its first taxable year under this subchapter (hereinafter in this paragraph called 'base period'), its excess profits net income—

"(A) For each taxable year of twelve months (beginning with the beginning of such base period) during which it was not in existence, shall be an amount equal to 8 per centum of the excess of—

"(i) the daily invested capital for the first day of the taxpayer's first taxable year beginning after December 31, 1939, over

"(ii) an amount equal to the same percentage of such daily invested capital as is applicable under section 720 in reduction of the average invested capital of the preceding taxable year;

"(B) for the taxable year of less than twelve months consisting of that part of the remainder of the base period during which it was not in existence, shall be the amount ascertained for a full year under subparagraph (A), multiplied by the number of days in such taxable year of less than twelve months and divided by the number of days in the twelve months ending with the close of such taxable year.

"(6) In no case shall the average base period net income be less than zero.

"(7) For computation of average base period net income in case of certain reorganizations, see section 742.

"(c) ADJUSTMENTS IN EXCESS PROFITS CREDIT ON ACCOUNT OF CAPITAL CHANGES.—For the purposes of this section—

"(1) The net capital addition for the taxable year shall be the excess, divided by the number of days in the taxable year, of the aggregate of the daily capital addition for each day of the taxable year over the aggregate of the daily capital reduction for each day of the taxable year.

"(2) The net capital reduction for the taxable year shall be the excess, divided by the number of days in the taxable year, of the aggregate of the daily capital reduction for each day of the taxable year over the aggregate of the daily capital addition for each day of the taxable year.

"(3) The daily capital addition for any day of the taxable year shall be the aggregate of the amounts of money and property paid in for stock, or as paid-in surplus, or as a contribution to capital, after the beginning of the taxpayer's first taxable year under this subchapter and prior to such day. In determining the amount of any property paid in, such property shall be included in an amount determined in the manner provided in section 718(a)(2). A distribution by the taxpayer to its shareholders in its stock or rights to acquire its stock shall not be regarded as money or property paid in for stock, or as paid-in surplus, or as a contribution to capital. The amount ascertained under this paragraph shall be reduced by the excess, if any, of the excluded capital for such day over the excluded capital for the first day of the taxpayer's first taxable year under this subchapter. For the purposes of this paragraph the excluded capital for any day shall be an amount equal to the sum of the following:

"(A) The aggregate of the adjusted basis (for determining loss upon sale or exchange) as of the beginning of such day, of obligations held by the taxpayer at the beginning of such day, which are described in section 22(b)(4) (A), (B), or (C) any part of the interest from which is excludible from gross income or allowable as a credit against net income; and

"(B) The aggregate of the adjusted basis (for determining loss upon sale or exchange) as of the beginning of such day, of stock of domestic corporations held by the taxpayer at the beginning of such day.

The daily capital addition shall in no case be less than zero. (For daily capital additions and reductions in case of certain reorganizations, see section 743.)

"(4) The daily capital reduction for any day of the taxable year shall be the aggregate of the amounts of distributions to shareholders, not out of earnings and profits, after the beginning of the taxpayer's first taxable year under this subchapter and prior to such day."

SEC. 30.713–1. *Excess profits credit based on income—Determination of average base period net income.*—(*a*) *Corporation in existence during the entire base period.*—In order for a corporation to determine the amount of its excess profits credit based on income for any particular taxable year, it is necessary first to compute the amount of the average base period net income, 95 per cent of which is the starting point for computing the excess profits credit based on income. If the corporation was in existence during the entire 48 months preceding the beginning of its first excess profits tax taxable year, the following steps are required for such computation:

(1) The excess profits net income for each of the taxable years in the base period (years beginning after December 31, 1935, and before January 1, 1940) is to be determined as provided in section 711(b).

(2) The aggregate of the excess profits net income for the taxable years in the base period, disregarding any taxable year for which the excess profits net income is less than zero, is to be computed.

(3) From such aggregate amount there is to be deducted the sum of the amounts by which the deductions plus the credit for dividends received exceed the gross income for those taxable years for which there is such an excess, except the year for which such excess is the greatest. If there is such an excess for only one taxable year, there shall be no such deduction. In computing such excess the amounts of gross income, deductions, and credit for dividends received must be adjusted to the extent required in determining excess profits net income for the taxable years in the base period under section 711(b). The credit for interest received allowed by section 26(a), though taken into account in computing excess profits net income, is not taken into account in computing the excess referred to in this paragraph.

(4) Such aggregate amount as so reduced is to be divided by the number of months in the taxable years in the base period and the quotient so obtained is to be multiplied by 12. In no case shall the average base period net income be less than zero.

The computation of the average base period net income may be illustrated by the following example:

Example: The excess profits net income, credit for interest received, credit for dividends received, deductions, and gross income (all computed by making the adjustments provided in section 711(b)) of the X Corporation (a domestic corporation), for the years 1936 to 1939, are as follows:

	1936	1937	1938	1939
Excess profits net income	$100,000	—$100,000	—$60,000	$30,000
Credit for interest received	10,000	10,000	10,000	10,000
Credit for dividends received	20,000	40,000	25,000	30,000
Deductions	60,000	150,000	150,000	90,000
Gross income	190,000	100,000	125,000	160,000

The average base period net income of the corporation is $20,000, computed as follows:

(*a*) Aggregate of excess profits net income for taxable years in base period (other than those years for which there is a deficit in such income), before reduction required by section 713(b)(1) ($100,000 plus $30,000)	$130,000
(*b*) Amount item (*a*) above is to be reduced as required by section 713(b)(1) and (4), i. e., excess for 1938 of deductions plus credit for dividends received over gross income, or $150,000 plus $25,000 minus $125,000	50,000
(*c*) Aggregate of excess profits net income for taxable years in base period as reduced (item (*a*) minus item (*b*))	80,000
(*d*) Average base period net income, $80,000 (item (*c*)), divided by 48 (total number of months in taxable years in base period), multiplied by 12, or $\frac{\$80,000}{48} \times 12$	20,000

(*b*) *Corporation in existence during only part of the base period.*—The base period of a corporation which was in existence during only part of the 48-month period preceding the beginning of its first excess profits tax taxable year is such period of 48 months. Section 713(b)(5) provides a method for determining the excess profits net income for such a corporation for that portion of such base period during which it was not in existence. For each taxable year of 12 months (beginning with the beginning of the base period) during which it was not in existence the excess profits net income is 8 per cent of the corporation's daily invested capital (see section 717) for the first day of its first excess profits tax taxable year reduced on account of inadmissible assets by the same ratio as would be applicable under section 720 in reduction of its average invested capital for the preceding taxable year. The excess profits net income for a taxable year of less than 12 months consisting of that part of the remainder of the base period during which it was not in existence is a proportionate part of such amount. The provisions 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 July 1, 1937, under the laws of a State of the United States. The corporation is not entitled under section 26(a) to any credit on account of Government obligations. The excess profits net income, credit for dividends received, deductions, and gross income (all computed by making the adjustments provided in section 711(b)) for the years 1938 and 1939 and that portion of the year 1937 during which it was in existence, are as follows:

	1937	1938	1939
Excess profits net income	—$40,000	—$20,000	$150,000
Credit for dividends received	10,000	30,000	35,000
Deductions	60,000	100,000	100,000
Gross income	30,000	110,000	285,000

The daily invested capital of the corporation for January 1, 1940, is $200,000. The percentage of such invested capital which would be applicable under section 720 in reduction of the average invested capital of the corporation on account of inadmissible assets for the calendar year 1939 is 5.

The average base period net income of the Y Corporation is $38,184.38, computed as follows:

(*a*) Daily invested capital for January 1, 1940	$200,000.00
(*b*) Amount equal to the same percentage (5 per cent) of item (*a*) as is applicable under section 720 in reduction of the average invested capital for preceding taxable year, 1939 ($200,000×.05)	10,000.00
(*c*) Excess of item (*a*) over item (*b*)	190,000.00
(*d*) Excess profits net income for 1836 ($190,000×.08)	15,200.00
(*e*) Excess profits net income for period from January 1, 1937, to June 30, 1937 $\left(\frac{\$15,200\times 181}{365}\right)$	7,537.53
(*f*) Aggregate of excess profits net income for taxable years in base period (other than those years for which there is a deficit in such income), before reduction required by section 713(b)(1) ($15,200 plus $7,537.53 plus $150,000)	172,737.53
(*g*) Amount item (*f*) above is to be reduced as required by section 713(b)(1)	20,000.00
(*h*) Aggregate of excess profits net income for taxable years in base period as reduced by item (*g*) above	152,737.53
(*i*) Average base period net income, $152,737.53 (item (*h*)), divided by 48 (total number of months in taxable year in base period) multiplied by 12, or $\frac{\$152,737.53}{48}\times 12$	38,184.38

SEC. 30.713–2. *Excess profits credit based on income.—Adjustments in excess profits credit on account of capital changes.*—Under the income method of determining the excess profits credit it is necessary to make adjustments for capital changes since the beginning of the first excess profits tax taxable year. The amount representing 95 per cent of the average base period net income which is the starting point in the computation of the excess profits credit shall be increased by 8 per cent of the net capital addition or reduced by 6 per cent of the net capital reduction. No capital adjustments are permitted or required in the case of a foreign corporation. Capital additions are money and property paid in for stock, or as paid-in surplus, or as a contribution to capital after the beginning of the first excess profits tax taxable year, adjusted for increases in excluded capital over the same period. Capital reductions are distributions since the beginning of the first excess profits tax taxable year which are not out of earnings and profits. The term "earnings and profits" includes earnings and profits of the taxable year and the accumulated earnings and profits of the corporation, whether accumulated before, on, or after March 1, 1913. For capital additions and reductions in case of certain reorganizations, see section 743. Adjustments on account of capital changes are illustrated by the following examples:

Example (1): Computation of net capital addition.—On January 1, 1940, the X Corporation, which makes its income tax returns on the calendar year basis, owns stock in another domestic corporation, acquired in 1938, the adjusted basis of which is $10,000 and $30,000 of State bonds which it had purchased in 1938 for $32,000.

The following were the only changes which occurred during 1940 that would affect the determination of the net capital addition or the net capital reduction of the corporation:

(*a*) On April 1, 1940, there was paid into the corporation for shares of its stock real estate having a basis to the corporation of $30,000.

(*b*) On July 1, 1940, there was paid into the corporation for shares of its stock Treasury bonds having a basis to the corporation of $22,400 and cash in the amount of $36,600.

The net capital addition of the corporation for 1940 is $40,759.02, computed as follows:

Period April 2, 1940, to July 1, 1940, inclusive.

(1) Real estate paid in for stock April 1, 1940	$30,000.00
(2) Less: Excess of excluded capital for each day of period over excluded capital on January 1, 1940 [1]	None
(3) Daily capital addition for each day of period (item (1) minus item (2))	30,000.00
(4) Aggregate of daily capital additions for period ($30,000 multiplied by 91, number of days in period)	2,730,000.00

Period July 2, 1940, to December 31, 1940, inclusive.

(5) Real estate, as above	$30,000.00
(6) Treasury bonds paid in for stock July 1, 1940	22,400.00
(7) Cash paid in for stock July 1, 1940	36,600.00
(8) Total	89,000.00

[1] (*a*) Excluded capital for each day of period:

(A) Stock of domestic corporations	$10,000
(B) State bonds	32,000
Total	42,000

(*b*) Excluded capital for January 1, 1940:

(A) Stock of domestic corporations	10,000
(B) State bonds	32,000
Total	42,000

(*c*) Excess of excluded capital for each day of period over excluded capital on January 1, 1940 — None

(9) Less: Excess of excluded capital for each day of period over excluded capital on January 1, 1940[2]	$22,400.00
(10) Daily capital addition for each day of period (item (8) minus item (9))	66,600.00
(11) Aggregate of daily capital additions for period ($66,600 multiplied by 183, number of days in period)	12,187,800.00
(12) Aggregate of daily capital additions for 1940 (item (4) plus item (11))	14,917,800.00
(13) Net capital addition ($14,917,800 divided by 366, number of days in taxable year)	40,759.02

Example (2): Computation of net capital reduction.—The Y Corporation, a domestic 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. Each share of preferred stock is entitled to receive annual dividends of $7, and $100 on complete liquidation, in priority to any payments on common stock, and is entitled to participate equally with each share of the common stock in either instance after the common stock has received a similar amount. The preferred stock is 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. 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 1, 1940, the company had a paid-in surplus of $6,000, consisting of the premium received on the preferred stock, earnings and profits of $30,000 accumulated prior to March 1, 1913, and earnings and profits accumulated since February 28, 1913, of $75,000. On July 1, 1940, the option with respect to the preferred stock is exercised and the entire amount of such stock is redeemed at $141 per share for a total of $141,000, such transaction being a partial liquidation under section 115(c). The corporation has no other transactions during the year 1940 which affect the capital of the corporation.

The net capital reduction of the corporation for 1940 is $53,000, computed as follows:

(*a*) Total amount distributed to preferred shareholders		$141,000
(*b*) Allocation of the amount distributed:		
(A) Attributable to par value	$100,000	
(B) Attributable to paid-in surplus	6,000	
(C) Attributable to earnings and profits accumulated as of July 1, 1940 (one-third of ($30,000 plus $75,000))	35,000	
Total	141,000	
(*c*) Amount of distribution not out of earnings and profits ($100,000 plus $6,000)		106,000
(*d*) Aggregate of the daily capital reduction from July 2, 1940, to December 31, 1940, both dates inclusive ($106,000 multiplied by 183, number of days in taxable year after distribution)		19,398,000
(*e*) Net capital reduction ($19,398,000 divided by 366, number of days in taxable year)		53,000
		*

[2] (*a*) Excluded capital for each day of period:

(A) Stock of domestic corporations		$10,000
(B) State bonds		32,000
(C) Treasury bonds		22,400
Total		64,400
(*b*) Excluded capital for January 1, 1940		42,000
(*c*) Excess of excluded capital for each day of period over excluded capital on January 1, 1940 ($64,400 minus $42,000)		22,400

"SEC. 714. EXCESS PROFITS CREDIT—BASED ON INVESTED CAPITAL.

"The excess profits credit, for any taxable year, computed under this section, shall be an amount equal to 8 per centum of the taxpayer's invested capital for the taxable year, determined under section 715."

SEC. 30.714–1. *Excess profits credit based on invested capital.*—Section 714 applies only to a corporation which under section 712 elects or is required to compute its excess profits credit under the invested capital method. Such credit is an amount equal to 8 per cent of its invested capital for the taxable year, regardless of the ratio of earnings to invested capital for previous taxable years. For computation of excess profits net income if excess profits credit based on invested capital is used, see section 711(a) (2).*

"SEC. 715. DEFINITION OF INVESTED CAPITAL.

"For the purposes of this subchapter the invested capital for any taxable year shall be the average invested capital for such year, determined under section 716, reduced by an amount computed under section 720 (relating to inadmissible assets). If the Commissioner finds that in any case the determination of invested capital, on a basis other than a daily basis, will produce an invested capital differing by not more than $1,000 from an invested capital determined on a daily basis, he may, under regulations prescribed by him with the approval of the Secretary, provide for such determination on such other basis. (For computation of invested capital in case of foreign corporations and corporations entitled to the benefits of section 251, see section 724.)

"SEC. 716. AVERAGE INVESTED CAPITAL.

"The average invested capital for any taxable year shall be the aggregate of the daily invested capital for each day of such taxable year, divided by the number of days in such taxable year.

"SEC. 717. DAILY INVESTED CAPITAL.

"The daily invested capital for any day of the taxable year shall be the sum of the equity invested capital for such day plus the borrowed invested capital for such day determined under section 719."

SEC. 30.715–1. *Determination of invested capital.*—It is necessary for a taxpayer using the invested capital method in computing the excess profits credit to determine the invested capital for the taxable year. This is not the invested capital at the beginning of the taxable year but the average invested capital for the taxable year, reduced by an amount computed under section 720, if the taxpayer owned any inadmissible assets during the taxable year. The average invested capital for the taxable year is the aggregate of the daily invested capital for each day of the taxable year, divided by the number of days in such taxable year. The daily invested capital is the sum of the equity invested capital, as defined in section 718, and the borrowed invested capital, as defined in section 719. The invested capital shall be computed in all cases on a daily basis.

If, during the taxable year, a corporation is not involved in a tax-free liquidation and neither receives new capital, whether paid in or borrowed, nor makes any distribution other than out of earnings and profits of the taxable year, nor retires indebtedness of the character includible in borrowed capital, its average invested capital for the taxable year is an amount equal to its daily invested capital for the first day of the taxable year.

In cases where the changes in invested capital are not numerous during the taxable year, the determination of the average invested capital may generally be simplified by taking the invested capital as of the first day of the taxable year and adding thereto such portion of each addition made during the year as the number of days remaining in the taxable year after such addition bears to the total number of days in the taxable year, and subtracting such portion of each reduction of capital as the number of days after such reduction bears to the total number of days in the taxable year. This paragraph may be illustrated by the following example:

Example: The invested capital of the X Corporation on January 1, 1940, is $500,000. The only changes in invested capital during the taxable year 1940 are as follows:

(*a*) On April 1, 1940, money amounting to $100,000 is paid in for stock.

(*b*) On October 1, 1940, a capital distribution is made amounting to $200,000.

Aggregate invested capital from January 1 to April 1, inclusive (92 days), $500,000×92	$46,000,000.00
Aggregate invested capital from April 2 to October 1, inclusive (183 days) ($500,000 plus $100,000)×183	109,800,000.00
Aggregate invested capital from October 2 to December 31, inclusive (91 days) ($600,000 minus $200,000)×91	36,400,000.00
Aggregate invested capital for 1940	192,200,000.00
Average invested capital for 1940 ($192,200,000 divided by 366, number of days in taxable year)	525,136.61

"SEC. 718. EQUITY INVESTED CAPITAL.

"(a) DEFINITION.—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

"(1) MONEY PAID IN.—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

"(2) PROPERTY PAID IN.—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined in the same manner as if the property were still held at the beginning of such taxable year. If such unadjusted basis is a substituted basis it shall be adjusted, with respect to the period before the property was paid in, in the manner provided in section 113(b)(2);

"(3) DISTRIBUTIONS IN STOCK.—Distributions in stock—

"(A) Made prior to such taxable year to the extent to which they are considered distributions of earnings and profits; and

"(B) Previously made during such taxable year to the extent to which they are considered distributions of earnings and profits other than earnings and profits of such taxable year;

"(4) EARNINGS AND PROFITS AT BEGINNING OF YEAR.—The accumulated earnings and profits as of the beginning of such taxable year; and

"(5) INCREASE ON ACCOUNT OF GAIN ON TAX-FREE LIQUIDATION.—In the case of the previous receipt of property (other than property described in the last sentence of section 113(a)(15)) by the taxpayer in complete liquidation of another corporation under section 112(b)(6), or the corresponding provision of a prior revenue law, an amount, with respect to each such liquidation, equal to the amount by which the aggregate of the amount of the money so received and of the adjusted basis, at the time of receipt, of all property (other than money) so received, exceeds the sum of:

"(A) The aggregate of the adjusted basis of each share of stock with respect to which such property was received; such adjusted basis of each share to be determined immediately prior to the receipt of any property in such liquidation with respect to such share, and

"(B) The aggregate of the liabilities of such other corporation assumed by the taxpayer in conection with the receipt of such property, of the liabilities (not assumed by the taxpayer) to which such property so received was subject, and of any other consideration (other than the stock with respect to which such property was received) given by the taxpayer for such property so received.

"(b) REDUCTION IN EQUITY INVESTED CAPITAL.—The amount by which the equity invested capital for any day shall be reduced as provided in subsection (a) shall be the sum of the following amounts—

"(1) DISTRIBUTIONS IN PREVIOUS YEARS.—Distributions made prior to such taxable year which were not out of accumulated earnings and profits;

"(2) DISTRIBUTIONS DURING THE YEAR.—Distributions previously made during such taxable year which are not out of the earnings and profits of such taxable year;

"(3) EARNINGS AND PROFITS OF ANOTHER CORPORATION.—The earnings and profits of another corporation which previously at any time were included in accumulated earnings and profits by reason of a transaction described in section 112 (b) to (e), both inclusive, or in the corresponding provision of a prior revenue law, or by reason of the transfer by such other corporation to the taxpayer of property the basis of which in the hands of the taxpayer is or was determined with reference to its basis in the hands of such other corporation, or would have been so determined if the property had been other than money; and

"(4) REDUCTION ON ACCOUNT OF LOSS ON TAX-FREE LIQUIDATION.—In the case of the previous receipt of property (other than property described in the last sentence of section 113(a)(15)) by the taxpayer in complete liquidation of another corporation under section 112(b)(6), or the corresponding provision of a prior revenue law, an amount, with respect to each such liquidation, equal to the amount by which the sum of—

"(A) The aggregate of the adjusted basis of each share of stock with respect to which such property was received; such adjusted basis of each share to be determined immediately prior to the receipt of any property in such liquidation with respect to such share, and

"(B) The aggregate of the liabilities of such other corporation assumed by the taxpayer in connection with the receipt of such property, of the liabilities (not assumed by the taxpayer) to which such property so received was subject, and of any other consideration (other than the stock with respect to which such property was received) given by the taxpayer for such property so received,

exceeds the aggregate of the amount of the money so received and of the adjusted basis, at the time of receipt, of all property (other than money) so received. The amount of the reduction under this paragraph shall not exceed the accumulated earnings and profits as of the beginning of such taxable year.

"(c) RULES FOR APPLICATION OF SUBSECTIONS (a) AND (b).—For the purposes of subsections (a) and (b)—

"(1) DISTRIBUTIONS TO SHAREHOLDERS.—The term 'distribution' means a distribution by a corporation to its shareholders, and the term 'distribution in stock' means a distribution by a corporation in its stock or rights to acquire its stock. To the extent that a distribution in stock is not considered a distribution of earnings and profits it shall not be considered a distribution. A distribution in stock shall not be regarded as money or property paid in for stock, or as paid-in surplus, or as a contribution to capital.

"(2) DISTRIBUTIONS IN FIRST SIXTY DAYS OF TAXABLE YEAR.—In the application of such subsections to any taxable year beginning after December 31, 1940, so much of the distributions (taken in the order of time) made during the first sixty days thereof as does not exceed the accumulated earnings and profits as of the beginning thereof (computed without regard to this paragraph) shall be considered to have been made on the last day of the preceding taxable year.

"(3) COMPUTATION OF EARNINGS AND PROFITS OF TAXABLE YEAR.—For the purposes of subsections (a)(3)(B) and (b)(2) in determining whether a distribution is out of the earnings and profits of any taxable year, such earnings and profits shall be computed as of the close of such taxable year without diminution by reason of any distribution made during such taxable year or by reason of the tax under this subchapter for such year and the determination shall be made without regard to the amount of earnings and profits at the time the distribution was made.

"(4) STOCK IN CASE OF MERGER OR CONSOLIDATION.—If a corporation owns stock in another corporation, and—

"(A) such corporations are merged or consolidated in a statutory merger or consolidation, or

"(B) such corporations are parties to a transaction which results in the elimination of such stock in a manner similar to that resulting from a statutory merger or consolidation, then such stock shall not be considered as property paid in for stock of, or as paid-in surplus of, or as a contribution to capital of, the corporation resulting from the transaction referred to in subparagraph (A) or (B).

"(d) For special rules affecting computation of property paid in for stock in connection with certain exchanges and liquidations, see section 751(a).

"(e) For determination of equity invested capital in special cases, see section 723."

SEC. 30.718–1. *Determination of daily equity invested capital—Money and property paid in.*—The equity invested capital for any day is determined as of the beginning of such day. The basis or starting point is found in the amount of money and property previously paid in for stock, or as paid-in surplus, or as a contribution to capital. For the purpose of determining equity invested capital, the amount of any property paid in is the unadjusted basis to the taxpayer for determining loss upon a sale or exchange under the law applicable to the taxable year for which the invested capital is being computed. If the property was disposed of before such taxable year, such unadjusted basis shall be determined as if the property were still held at the beginning of such taxable year.

If the basis to the taxpayer is cost and stock was issued for the property, the cost is the fair market value of such stock at the time of its issuance. If the stock had no established market value at the time of the exchange, the fair market value of the assets of the company at that time should be determined and the liabilities deducted. The resulting net worth will be deemed to represent the total value of the outstanding stock. In determining net worth for the purpose of fixing the fair market value of the stock at the time of the exchange, the property paid in for such stock shall be included in the assets at its fair market value at that time.

If stock having no established market value is issued for intangible property, and it is necessary to determine the fair market value of such property, the following factors, among others, may be taken into consideration in determining such value: (*a*) The earnings attributable to such intangible assets while in the hands of the predecessor owner; and (*b*) any cash offers for the purchase of the business, including the intangible property, at or about the time of its acquisition. A corporation claiming a value for intangible property paid in for stock should file with its return a full statement of the facts relating to such valuation.

If the property was acquired after December 31, 1920, by a corporation from a shareholder as paid-in surplus or from any person as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor if the transfer had not been made. (See section 113(a)(8).) If so acquired prior to January 1, 1921, the basis is the fair market value of the property at the time it was paid in. If the basis is the transferor's basis, then such adjustments shall be made as are provided in section 113(b)(2) with respect to the period before the property was paid in. Thus, if A paid into a corporation in 1930 as paid-in surplus certain improved real estate purchased by him in 1920 for $20,000, with respect to which depreciation was allowed for the period held by him in amounts aggregating $6,000 (the full amount allowable), A's basis of $20,000 shall be reduced by $6,000 for the purpose of computing the invested capital of the corporation.

The fact that the money or property paid in has been lost, destroyed, or otherwise disposed of shall not reduce the invested capital, except as such facts are reflected in the earnings and profits as of the beginning of the taxable year. As to cases with respect to which the equity invested capital at the beginning of the year can not be determined, see section 723. As to determination of amount of property paid in for stock in connection with certain exchanges, see section 751(a).

Section 718(c)(4), which provides that in certain cases stock acquired by a corporation shall not be treated as property paid in for stock, or as paid-in surplus, or as a contribution to capital, is for the purpose of avoiding duplication in invested capital. Thus, for example, if the X Corporation owns stock of the Y Corporation and both corporations are merged into the Z Corporation, the Y Corporation stock received by the Z Corporation from the X Corporation may not be treated as property paid in for stock, or as paid-in surplus, or as a contribution to capital of the Z Corporation. This avoids duplication, since the assets of the Y Corporation, against which such stock was issued, are treated as property paid in for stock, or as paid-in surplus, or as a contribution to capital of the Z Corporation. Section 718(c)(4) does not apply to a section 112(b)(6) liquidation where no possibility of duplication exists.*

SEC. 30.718-2. *Determination of daily equity invested capital—Accumulated earnings and profits—(a) In general.*—The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 30.718-4 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax. In computing accumulated earnings and profits as of the beginning of the taxable year, a taxpayer keeping its books and making its income tax returns on the accrual basis shall subtract the income and excess profits taxes for the preceding taxable year. If there is a deficit in the accumulated earnings and profits as of the beginning of the taxable year, such deficit shall not be taken into account in determining invested capital, and in such cases the earnings and profits as of the beginning of the taxable year shall be considered as zero, but subsequent earnings and profits shall be applied against such deficit. Unrealized appreciation in value of property is not a factor in determining earnings and profits.

(*b*) *Current earnings and profits.*—Earnings and profits of any taxable year can not be included in the computation of invested capital for that year. If a dividend is declared and paid during any year out of the earnings and profits of that year and the stockholders pay back into the corporation all or a substantial part of the amount of such dividends, the amount so paid back can not be included in the computation of invested capital for that year unless the corporation shows by evidence satisfactory to the Commissioner that the dividends were paid in good faith and without any understanding, express or implied, that they were to be paid back.*

SEC. 30.718-3. *Determination of daily equity invested capital.—Distributions in stock.*—A distribution made prior to the taxable year by a corporation in its stock, or in rights to acquire its stock, to the extent to which it constitutes a distribution of earnings and profits of the corporation, constitutes an item of invested capital. Such a distribution made during the taxable year out of earnings and profits other than out of the earnings and profits of that year is also an item of invested capital. If a stock dividend is paid out of capital and not out of earnings and profits, or is of such a character as not to be subject to tax in the hands of a distributee because exempt as a stock dividend either by statute or otherwise, it is not deemed to constitute a distribution and does not reduce the earnings and profits account. See section 115(h).*

SEC. 30.718-4. *Determination of daily equity invested capital—Reductions by distribution.*—The amount of the daily equity invested capital as partially determined by taking the aggregate of the sums described in section 718(a) shall be reduced by the amount of the distributions made in prior taxable years which were not out of accumulated earnings and profits plus the amount of the distributions previously made during the taxable year which were not out of the earnings or profits of such year. In determining whether a distribution is out of the earnings and profits of any taxable year, such earnings and profits shall be computed as of the close of such taxable year without diminution by reason of any distribution made during such taxable year or by reason of the excess profits tax imposed by the Excess Profits Tax Act of 1940, and without regard to the amount of earnings and profits at the time the distribution was made.

For example, if a corporation making a return on the calendar year basis had accumulated earnings and profits as of the beginning of the taxable year of $50,000, and earnings and profits during the taxable year (without diminution by any distributions or the excess profits tax for the taxable year) of $150,000,

all earned during the last six months of the taxable year, and distributed $175,000 as dividends during the taxable year, $56,000 on April 1, $70,000 on July 1, and $49,000 on October 1, six-sevenths of each distribution will be deemed to have been paid out of earnings of the taxable year and one-seventh from accumulated earnings and profits, so that accumulated earnings and profits will be reduced by $8,000 beginning April 2, by an additional $10,000 beginning July 2, and by an additional $7,000 beginning October 2.

In computing accumulated earnings and profits as of the beginning of the taxable year and in determining what distributions during the taxable year are made out of the earnings and profits of such year, for the purposes of section 718 (a) and (b) distributions made during the first 60 days of any taxable year beginning after December 31, 1940, are deemed, to the extent they do not exceed the accumulated earnings and profits as of the beginning of the taxable year, to have been made on the last day of the preceding taxable year. In applying such rule, such distributions shall be considered in the order of time. For example, if a corporation on the calendar year basis has accumulated earnings or profits of $100,000 on January 1, 1941, and makes distributions of $75,000 on January 15, 1941, and $50,000 on February 15, 1941, the distribution of January 15, 1941, and $25,000 of the distribution of February 15, 1941, are considered as having been made on December 31, 1940.

A distribution is considered to be made on the date it is payable, except that where no date is set for its payment, the distribution is considered to be made on the date when it is declared, and except that distributions payable during the first 60 days of a taxable year beginning after December 31, 1940, are considered to be distributions made on the last day of the preceding taxable year to the extent such distributions do not exceed the accumulated earnings and profits as of the beginning of the taxable year.

The purchase by a corporation of its own stock for investment does not of itself result in a reduction of invested capital. But see section 30.720–1 relative to inadmissible assets. If, however, the corporation subsequently cancels such stock, invested capital is reduced, beginning with the day following such cancellation, by so much of the adjusted basis of such stock in the hands of the corporation as is not properly chargeable to earnings and profits of the taxable year. If stock is purchased for retirement, there is a distribution on the date of purchase of the amount paid therefor and the invested capital is reduced by the amount thereof not properly chargeable to earnings and profits of the taxable year.*

SEC. 30.718–5. *Determination of daily equity invested capital—Adjustments on account of receipt of property on certain tax-free liquidations.*—If the taxpayer has previously received property (other than property described in the last sentence of section 113(a)(15)) in complete liquidation of another corporation in which no gain or loss was recognized under section 112(b)(6) or the same section of the Revenue Act of 1936 or 1938, the invested capital shall be increased by an amount equal to the excess of the aggregate of the money and the adjusted basis, at the time of receipt, of the property other than money so received over the sum of the adjusted basis of the stock with respect to which such property was received and the aggregate of the liabilities assumed by the taxpayer, or to which the property received was subject, and any other consideration given by the taxpayer for such property. If the aggregate of the adjusted basis of such stock plus such liabilities and other consideration given for the property so received exceeds such money and the adjusted basis of such property, then such excess shall be deducted from the invested capital to the extent that such excess does not exceed the accumulated earnings and profits as of the beginning of the taxable year. The term "adjusted basis" as used in section 718(a)(5) and (b)(4) means adjusted basis for determining loss. The provisions of this paragraph may be illustrated by the following examples:

Example (1): The X Corporation owns all the outstanding stock of the Y Corporation for which it paid $25,000, which is its adjusted basis for determining loss. The Y Corporation is completely liquidated during the 1940 taxable year of the X Corporation in accordance with section 112(b)(6). The X Corporation received upon such liquidation assets having an adjusted basis of $35,000 for determining loss. Under section 718(a)(5) there is an increase in equity invested capital of $10,000, computed as follows:

Adjusted basis to the Y Corporation of property received by the X Corporation in liquidation	$35,000
Less:	
Adjusted basis to the X Corporation of stock in the Y corporation	25,000
Increase in equity invested capital	10,000

Example (2): If in the above example the X Corporation had paid $40,000, instead of $25,000, for the stock of the Y corporation and had accumulated earnings and profits as of the beginning of the taxable year of $10,000, then under the application of section 718(b)(4) there is a decrease in equity invested capital of $5,000 as shown by the following computation:

Adjusted basis to the X Corporation of stock in the Y Corporation	$40,000
Less:	
Adjusted basis to the Y Corporation of property received by the X Corporation in liquidation	35,000
Reduction in equity invested capital	5,000

If at the beginning of a subsequent taxable year the accumulated earnings and profits are less than $5,000, the amount of the reduction required by section 718(b)(4) for such taxable year will be limited to the amount of such accumulated earnings and profits.

If the earnings and profits of another corporation previously at any time were included in the accumulated earnings and profits of the taxpayer by reason of a transaction referred to in section 718(b)(3), the amount of such earnings and profits shall be deducted in determining the equity invested capital. The provisions of this paragraph may be illustrated by the following example:

Example: The Y Corporation prior to July 1, 1939, had capital stock outstanding of $20,000 and accumulated earnings and profits of $5,000. The X Corporation was organized on July 1 to take over all the assets of the Y Corporation in exchange for all of its stock. Stock in the amount of $25,000 was issued by the X Corporation in exchange for all the assets of the Y Corporation which had an adjusted basis to the Y Corporation of $25,000. Since the property of the Y Corporation in the amount of $25,000 is a part of the invested capital of the X Corporation as property paid in for stock and in addition the accumulated earnings and profits of the Y Corporation amounting to $5,000 are considered part of the accumulated earnings and profits of the X Corporation,[1] the invested capital of the corporation for the taxable year must be reduced by $5,000, the amount of the earnings and profits of the Y Corporation, as provided by section 718(b)(3).*

"SEC. 719. BORROWED INVESTED CAPITAL.

"(a) BORROWED CAPITAL.—The borrowed capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following:

"(1) The amount of the outstanding indebtedness (not including interest, and not including indebtedness described in section 751(b) relating to certain exchanges) of the taxpayer which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus,

"(2) In the case of a taxpayer having a contract (made before the expiration of 30 days after the date of the enactment of the Second Revenue Act of 1940) with a foreign government to furnish articles, materials, or supplies to such foreign government, if such contract provides for advance payment and for repayment by the vendor of any part of such advance payment upon cancellation of the contract by such foreign government, the amount which would be required to be so repaid if cancellation occurred at the beginning of such day, but no amount shall be considered as borrowed capital under this paragraph which has been includible in gross income.

"(b) BORROWED INVESTED CAPITAL.—The borrowed invested capital for any day of any taxable year shall be determined as of the begin-

[1] *Commissioner* v. *Sansome* (60 Fed. (2d), 931).

ning of such day and shall be an amount equal to 50 per centum of the borrowed capital for such day."

SEC. 30.719-1. *Borrowed invested capital.*—The borrowed invested capital for any day of the taxable year is 50 per cent of the borrowed capital for such day determined as of the beginning of such day. Borrowed capital is defined to mean:

(*a*) Outstanding indebtedness (other than interest and indebtedness described in section 751(b) relating to certain exchanges, but including indebtedness assumed or to which the taxpayer's property is subject) of the taxpayer which is evidenced by a bond, a promissory note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus

(*b*) In the case of a corporation having a contract, made before November 8, 1940, with a foreign government to furnish articles, materials, or supplies to such foreign government, amounts received as advance payment in connection with and as provided by such contract, to the extent such amounts would be repayable pursuant to the terms of the contract, if cancellation by such foreign government occurred at the beginning of the day for which the borrowed capital is being ascertained, but no amount shall be included as borrowed capital which has been includible in gross income.

In order for any indebtedness to be included in borrowed capital it must be bona fide. It must be one incurred for business reasons and not merely to increase the excess profits credit. If indebtedness of the taxpayer is assumed by another person it ceases to be borrowed capital of the taxpayer. For such purpose an assumption of indebtedness includes the receipt of property subject to indebtedness.

Whether outstanding certificates designated by such names as "debenture preferred stock" or "guaranteed preferred stock" constitute borrowed capital depends upon whether the holder has a proprietary interest in the corporation or has the rights of a creditor, determined in the light of all the facts. The name borne by the certificate is of little importance. More important attributes to be considered are whether or not there is a maturity date, the source of payment of any "interest" or "dividend" specified in the certificate (whether only out of earnings or out of capital and earnings), rights to enforce payment, and other rights as compared with those of general creditors.

The term "certificate of indebtedness" includes only instruments having the general character of investment securities issued by a corporation as distinguishable from instruments evidencing debts arising in ordinary transactions between individuals. Borrowed capital does not include indebtedness incurred by a bank arising out of the receipt of a deposit and evidenced, for example, by a certificate of deposit, a passbook, a cashier's check, or a certified check.

The provisions of section 719(a)(2) relating to contracts with a foreign government may be illustrated by the following example:

Example: The X Corporation, which makes its income tax returns on the calendar year basis and reports its income on the accrual basis, entered into a contract with a foreign government on November 1, 1940, for the manufacture and delivery of certain parts for aircraft, and received thereunder an advance payment as of that date of $500,000. The contract provided for its cancellation by the vendee, and further provided that the advance payment should be returned upon such cancellation less the sum of $100,000 and $5,000 for each unit delivered before cancellation. Ten units were delivered December 1, 1940, another 10 units December 30, 1940, and the contract was canceled December 31, 1940, before any other deliveries had been made. Borrowed invested capital would be increased $200,000 (50 per cent of $400,000) for each day beginning November 2, 1940, and ending December 1, 1940; $175,000 (50 per cent of $350,000) for each day beginning December 2, 1940, and ending December 30, 1940; and $150,000 (50 per cent of $300,000) for one day, December 31, 1940.*

"SEC. 720. ADMISSIBLE AND INADMISSIBLE ASSETS.

"(a) DEFINITIONS.—For the purposes of this subchapter—

"(1) The term 'inadmissible assets' means—

"(A) Stock in corporations except stock in a foreign personal-holding company; and

"(B) Except as provided in subsection (d), obligations described in section 22(b)(4) any part of the interest from which is excludible from gross income or allowable as a credit against net income.

"(2) The term 'admissible assets' means all assets other than inadmissible assets.

"(b) RATIO OF INADMISSIBLES TO TOTAL ASSETS.—The amount by which the average invested capital for any taxable year shall be reduced as provided in section 715 shall be an amount which is the same percentage of such average invested capital as the percentage which the total of the inadmissible assets is of the total of admissible and inadmissible assets. For such purposes, the amount attributable to each asset held at any time during such taxable year shall be determined by ascertaining the adjusted basis thereof (or, in the case of money, the amount thereof) for each day of such taxable year so held and adding such daily amounts. The determination of such daily amounts shall be made under regulations prescribed by the Commissioner with the approval of the Secretary. The adjusted basis shall be the adjusted basis for determining loss upon sale or exchange as determined under section 113.

"(c) COMPUTATION IF SHORT-TERM CAPITAL GAIN.—If during the taxable year there has been a short-term capital gain with respect to an inadmissible asset, then so much of the amount attributable to such inadmissible asset under subsection (b) as bears the same ratio thereto as such gain bears to the sum of such gain plus the dividends and interest on such asset for such year, shall, for the purpose of determining the ratio of inadmissible assets to the total of admissible and inadmissible assets, be added to the total of admissible assets and subtracted from the total of inadmissible assets.

"(d) TREATMENT OF GOVERNMENT OBLIGATIONS AS ADMISSIBLE ASSETS.—If the excess profits credit for any taxable year is computed under section 714, the taxpayer may in its return for such year elect to increase its normal-tax net income for such taxable year by an amount equal to the amount of the interest on all obligations held during the taxable year which are described in section 22(b)(4) any part of the interest from which is excludible from gross income or allowable as a credit against net income. In such case, for the purposes of this section, the term 'admissible assets' includes such obligations, and the term 'inadmissible assets' does not include such obligations."

SEC. 30.720–1. *Reduction of average invested capital for inadmissible assets.*—If a taxpayer owns any "inadmissible assets" on any day during the taxable year, then section 715 relating to the computation of invested capital requires the average invested capital to be reduced in the same ratio as the inadmissible assets bear to the total assets. The term "inadmissible assets" means stock in all corporations, domestic or foreign, except stock in a foreign personal-holding company, and all obligations described in section 22(b)(4), any part of the interest from which is excludible from gross income or allowable as a credit against net income. Stock held in the treasury of the issuing corporation is an inadmissible asset. The term "admissible assets" means all assets other than inadmissible assets. However, if a taxpayer in its return for a taxable year elects to increase its normal-tax net income for that year for the purpose of the excess profits tax by including all the interest derived from the obligations described in section 22(b)(4), all such obligations shall be considered admissible assets for such taxable year. For the purposes of the preceding sentence, (A) the term "interest" includes, in the case of obligations issued at a discount, so much of such discount as (for purposes of determining gain or loss upon sale or other disposition) is treated as interest in the hands of the taxpayer for the taxable year, and (B) the term "obligations described in section 22(b)(4)" includes obligations, whether or not issued at a discount, the discount on which, if issued at a discount, would be so treated. The following steps are necessary in the application of section 720:

(*a*) There must first be determined the adjusted basis for determining loss upon the sale or exchange, as provided in section 113, for each asset, or, in the case of money, the amount thereof, owned at the beginning of each day during the taxable year.

(*b*) There must then be determined the aggregate of the admissible assets and the aggregate of the inadmissible assets for the taxable year.

(c) The average invested capital for the taxable year must then be reduced by the percentage which the total of the inadmissible assets is of the total of the admissible and inadmissible assets.

If the taxpayer had a short-term capital gain during the taxable year with respect to any inadmissible asset, then the amount of the admissible assets shall be increased and the amount of the inadmissible assets shall be decreased by so much of the amount attributable to such inadmissible asset as such gain bears to the sum of such gain plus the dividends or interest on such asset for such year.

The amount of admissible assets and the amount of inadmissible assets shall be determined as of the beginning of each day. If, however, it is impracticable to determine such amounts as of the beginning of each day but the amounts held on a given day of each month throughout the year or at other regular intervals not exceeding one year can be determined, the amounts held as of the beginning of each day of such month or other period may be determined by dividing by two the sum of the amounts of such assets held at the beginning of the period and the amounts held at the end of the period. If at any time a substantial change has taken place either in the amount of inadmissible assets or in the total amount of admissible and inadmissible assets, the effect of such change shall be averaged exactly from the date on which it occurred. Ordinarily the taxpayer will be able to determine the amount of inadmissible assets actually held on each day of the taxable year. The fact that it may be impracticable to determine the amount of admissible assets actually held on each day of the taxable year will not relieve the taxpayer from the necessity of determining the actual amount of inadmissible assets held unless such determination is likewise impracticable.

The adjustment for inadmissible assets may be illustrated by the following example:

Example: The average invested capital of the X Corporation for its taxable year 1940, determined under section 716, is $1,000,000. On January 1, 1940, the corporation held bonds of a State which it had previously purchased for $60,000, and stock in another corporation (not a foreign personal holding company) which it had previously purchased for $25,000. On July 1, 1940, it purchased stock in another corporation (not a foreign personal holding company) for $20,000, and on July 4, 1940, additional State bonds for $48,700. On September 1, 1940, it sold for $29,000 the stock purchased on July 1, 1940, after having received a dividend of $1,000 thereon. The aggregate of the daily amounts of the admissible and inadmissible assets for the taxable year 1940 is $400,000,000. The corporation does not elect to increase its normal-tax net income for excess profits tax purposes by the amount of the interest derived from the State bonds.

The invested capital of the X Corporation as defined in section 715 is $900,000, computed as follows:

Average invested capital for 1940	$1,000,000
Less:	
Amount computed under section 720 for inadmissible assets (10 per cent of $1,000,000, see Schedule I below)	100,000
Invested capital for 1940 as defined in section 715	900,000

Schedule I.

(a) Aggregate of the daily amounts of inadmissible assets for the year 1940 before adjustment for short-term capital gain:		
(1) State bonds held January 1, 1940 ($60,000 multiplied by 366 (days))	$21,960,000	
(2) State bonds purchased July 4, 1940 ($48,700 multiplied by 180 (days))	8,766,000	
(3) Stock in domestic corporation held January 1, 1940 ($25,000 multiplied by 366 (days))	9,150,000	
(4) Stock in domestic corporation purchased July 1, 1940, for $20,000 and sold September 1, 1940, for $29,000 ($20,000 multiplied by 62 (days))	1,240,000	
		$41,116,000

(b) Less: Adjustment on account of short-term capital gain (see Schedule II below)	$1,116,000
(c) Aggregate of the daily amounts of the inadmissible assets after adjustment for short-term capital gain (item (a) minus item (b))	$40,000,000
(d) Aggregate of the daily amounts of admissible and inadmissible assets for the year 1940 (this item being unaffected by the adjustment on account of the short-term capital gain)	$400,000,000
(e) Ratio of aggregate of daily amounts of inadmissible assets (item (c) above) to aggregate of daily amounts of admissible and inadmissible assets (item (d) above), $40,000,000 divided by $400,000,000—per cent	10

Schedule II.

Computation of adjustment on account of short-term capital gain:	
(a) Amount attributable to inadmissible asset before adjustment under section 720(c) for short-term capital gain (stock in domestic corporation purchased July 1, 1940, for $20,000 and sold September 1, 1940, for $29,000), $20,000 multiplied by 62 (days))	$1,240,000
(b) Amount of gain realized ($29,000 minus $20,000)	$9,000
(c) Sum of gain plus dividends received ($9,000 plus $1,000)	$10,000
(d) Ratio of gain (item (b)) to sum of gain plus dividends received (item (c)), $9,000 divided by $10,000—per cent	90
(e) Adjustment on account of short-term capital gain, 90 per cent of $1,240,000 (item (a))	$1,116,000

"SEC. 721. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

"If there is includible in the gross income of the taxpayer for any taxable year an item of income of any one or more of the following classes:

"(a) Arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

"(b) Constituting an amount payable under a contract the performance of which required more than 12 months; or

"(c) Resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; or

"(d) Includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's accounting period or method of accounting; or

"(e) In the case of a lessor of real property, amounts included in gross income for the taxable year by reason of the termination of the lease; or

"(f) Dividends on stock of foreign corporations, except foreign personal holding companies;

and, in the light of the taxpayer's business, it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class, the item includible in the gross income of the taxable year is grossly disproportionate to the gross income of the same class in the four previous taxable years, then: (1) the amount of such item attributable to any previous taxable year or years shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary; (2) the amount of such item attributable to any future taxable year or years shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary and shall, for the purposes of this subchapter, be included in the gross income for the future year or years to which attributable; and (3) the tax under this subchapter for the taxable year (in which the whole of such item would, without regard to this section, be includible) shall not exceed the sum of:

"(A) The tax under this subchapter for such taxable year computed without the inclusion in gross income of the portion of such item which is attributable to any other taxable year, and

"(B) The aggregate of the increase in the tax under this subchapter which would have resulted for each previous taxable year to which any portion of such item is attributable, computed as if an amount equal to such portion had been included in gross income for such previous taxable year."

SEC. 30.721–1. *Abnormalities in income in taxable year.*—(*a*) If there is includible in gross income an item of any one of six classes of income enumerated in section 721 properly attributable in whole or in part to a year other than the taxable year and if either—

in the light of the taxpayer's business it is abnormal for it to receive income of such class, or

though its receipt is normal, the amount thereof is grossly disproportionate to the gross income of the same class realized by the taxpayer in the four previous taxable years,

then the amount of such income attributable to previous and to future taxable years shall for excess profits tax purposes be determined in accordance with these regulations. The excess profits tax for the taxable year shall be the lesser of the following:

Such tax computed without regard to section 721; or

The sum of the excess profits tax for the taxable year computed without the inclusion in gross income of the portion of the abnormal income which is attributable to any other taxable year plus the additional excess profits tax which would have resulted for each previous taxable year if the gross income for such taxable year had been increased by the inclusion therein of the portion of the abnormal income attributable thereto.

(*b*) If the taxpayer normally derives income of the same class but the item or items includible in gross income for the taxable year are grossly disproportionate to the average income of such class in the preceding four taxable years, such item or items shall be subject to the treatment provided by section 721.

(*c*) Section 721 has no effect upon the computation of base period net income or of earnings and profits and therefore does not affect the computation of the excess profits credit. Similarly, it has no application in the determination of taxes other than the excess profits tax imposed by Subchapter E of Chapter 2. Amounts allocated to future years are to be included in gross income for such years for excess profits tax purposes. If, however, the taxpayer completely liquidates or otherwise disposes of all its assets prior to the close of the last year to which such amounts are allocated, all amounts not theretofore included in gross income shall be included in gross income for the taxable year in which the liquidation is completed or the assets transferred.

(*d*) A taxpayer claiming the benefits of section 721 shall file with its excess profits tax return a statement showing (1) the amount and nature of the item of income claimed to be abnormal; (2) the method used in allocating such abnormal income and the amount allocated to each year; (3) a schedule showing by years the amount, if any, of income of the same class derived during the four taxable years immediately preceding the taxable year; and (4) all other facts upon which the taxpayer relies.*

SEC. 30.721–2. *Income arising out of a claim, award, judgment, or decree, or interest thereon.*—The first class of potentially abnormal income is income arising out of a claim, award, judgment, or decree, or interest thereon. All items of income covered by this section are of the same type or class. Therefore, in determining whether income arising out of a judgment, for example, is abnormal either in kind or in amount, account must be taken not only of other judgment income, if any, received in preceding taxable years, but also of any income arising out of claims, awards, and decrees, and interest thereon, so received.

In determining the portions of income of the class described which are attributable to other taxable years, due regard shall be given to the nature of the claim upon which the recovery is founded. Allocation will generally be made to the year or years during which occurred the exploitation, removal, or use, as the case may be, of the property right forming the subject matter of the claim, award, judgment, or decree. Thus, in the case of a judgment for infringement of a patent, the number of units produced through the use by the infringer of

such patent in the respective years involved shall constitute a proper basis of allocation. Similarly, if the removal of minerals forms the basis of the recovery, the units removed in the respective years shall constitute a proper basis of allocation. The income arising from awards of the Mixed Claims Commission, United States and Germany, to the extent they constitute compensation for past losses, shall be attributed to the years during which such losses occurred. Interest shall be attributed to the years for which it was allowed.

This section may be illustrated by the following example:

Example: Based upon encroachment by the Y Corporation upon mineral property, the X Corporation in 1941 obtains judgment for and payment of $630,000. The X Corporation has not in any prior year derived income from any like source. As the judgment is based upon $1 per ton for ore removed in each year, the amount received is allocated as follows:

Year.	Tonnage.	Gross income.
1938	80,000	$80,000
1939	200,000	200,000
1940	150,000	150,000
1941	200,000	200,000
Total		630,000

For the purposes of the computation of the excess profits tax there shall be included in gross income for the year 1941 the amount of $200,000. The amount of $150,000 allocated to 1940 affects the total 1941 excess profits tax as explained below. The amount allocated to the years 1938 and 1939 is not subject to excess profits tax for the reason that the excess profits tax is applicable only to years beginning after December 31, 1939.

The excess profits tax for the year 1941 shall be determined as follows:

(1) An excess profits tax for 1941 shall be computed without regard to section 721, that is, by including in gross income the item of $630,000, and

(2) A partial excess profits tax for 1941 shall be computed on the net income arrived at by including in gross income only $200,000 of the item of $630,000, and to the partial tax so computed there shall be added the increase in the excess profits tax which would result from the inclusion in gross income for the year 1940 of $150,000 of the item of $630,000.

The excess profits tax for 1941 is either (1) or (2), whichever is the lesser.

To arrive at the increase in the excess profits tax for 1940 which would result from the inclusion in the gross income for such year of $150,000 of the item of $630,000, the excess profits tax shall (but only for the purpose of determining the 1941 excess profits tax liability) be computed first by including the item of $150,000 in the gross income, and second by excluding such amount from the gross income. The excess of the amount obtained as the result of the first computation over the amount obtained as the result of the second computation represents such increase.

If in the above example, in addition to the principal amount, interest had been added to the judgment, such interest would be also properly allocable as between the year 1941 and prior taxable years in accordance with the method sanctioned by the court in settling the amount of such interest. If the portion of the total interest attributable to the respective years can not be ascertained from the judgment, such interest may be allocated among such years, upon the basis of the respective portions of the principal amount attributable to such years, giving effect to the period of time each portion remained unpaid.*

SEC. 30.721–3. *Long-term contracts.*—The second class of potentially abnormal income is income constituting an amount payable under a contract the performance of which required more than 12 months. Such contracts are hereinafter referred to in this section as long-term contracts. In determining whether performance required a period of more than 12 months, only the period beginning with the commencement of the work and ending with its completion shall be taken into account. If less than 12 months elapse between beginning of the work and its completion the contract is not a long-term contract, even though more than 12 months may have elapsed between the execution of such con-

ract and the completion of its performance. In general, amounts payable under long-term contract are entitled to the treatment provided by section 721 only f the taxpayer reports its income on the completed contract basis.

Amounts payable under a long-term contract falling within the provisions f this section shall be attributed to the taxable years during which expendiures were made on account of such contract in the proportion which the mount of such expenditures made during each such year bears to the total f such expenditures, account being taken of the material and supplies on hand t the beginning and end of each such year for use in connection with the work nder the contract but not yet so applied.

This section may be illustrated by the following example:

Example: In 1941 the A Corporation which makes its income tax returns on the alendar year basis completes two contracts for the construction of buildings, ne of which was begun in 1938 and the other in 1939. Its gross income for 941 from the two long-term contracts amounts to $1,000,000, of which $800,000 s derived from the 1938 contract and $200,000 from the 1939 contract. It eports income of this class upon the completed contract basis in accordance vith section 19.42–4(*b*), Regulations 103, and corresponding provisions of prior egulations. Its gross income from long-term contracts for the years 1937, 1938, 939, and 1940 amounted to $250,000, $350,000, $200,000, and $400,000, respecively. The gross income ($1,000,000) arising from long-term contracts in 1941 s therefore grossly disproportionate to the average gross income ($300,000) of hat class for the years 1937, 1938, 1939, and 1940. Such gross income for 1941 s therefore subject to the provisions of section 721. Assuming that the total xpenditures properly applicable to the 1938 contract amount to $5,000,000, of vhich the respective sums of $500,000, $1,250,000, $1,500,000, and $1,750,000 are llocable to the years 1938, 1939, 1940, and 1941, then the item of $800,000 ttributable to the 1938 contract is allocable to those years in the respective mounts of $80,000, $200,000, $240,000, and $280,000. In like manner the amount f $200,000 representing the gross income derived from the 1939 contract shall e allocated to the years 1939, 1940, and 1941 in proportion to the expenditures pplicable to that contract. For method of computation of the excess profits ax for the year 1941, see the example in section 30.721–2.*

SEC. 30.721–4. *Exploration, discovery, prospecting, research, or development.*— he third class of potentially abnormal income is income resulting from exloration, discovery, prospecting, research, or development of tangible property such as mines, oil-producing property, and timber tracts), patents, formulae, r processes, or any combination thereof, extending over a period of more than 2 months. The exploration, discovery, prospecting, research, or development ıust be that of the taxpayer. Income resulting from activities of such a charcter carried on by a predecessor is not entitled to the treatment provided by ection 721.

Ordinarily, the time when exploration, discovery, prospecting, research, or delopment begins will be deemed to be when the first expenditures on account hereof are incurred. Such activities must be related to the particular property ut of which the income arises. Moreover, the income subject to the treatment rovided in section 721 does not include profit resulting from manufacturing or ther activities not specified in section 721.

Income of the class described in this section, if found to be abnormal either ı kind or in amount, is to be attributed to the taxable years in the period ommencing with the beginning of the exploration, discovery, prospecting, reearch, or development and ending with the close of the taxable year. In makıg such allocation, due regard should be given to expenditures, progress of the articular activity, and all other factors tending to establish the extent to which he income subsequently realized is attributable to the activities for any portion f the total period. However, in any case the income may be attributed ratably) the months in the period commencing with the beginning of the exploration, iscovery, prospecting, research, or development and ending with the close of he taxable year. This method may be illustrated by the following examples:

Example (1): In January, 1938, the X Corporation began the development f a certain device on which it expended considerable sums. The corporation ecures a patent on such device in December, 1940, and in the same month sells ıch patent at a profit of $250,000. It did not in any of the four immediately receding years derive income of the class specified in (c) of section 721. Onehird of the item of $250,000 is, therefore, attributable to each of the years 1938,

1939, and 1940 for excess profits tax purposes. For method of computation of the excess profits tax for the year 1940, see the example in section 30.721–2.

Example (2): The A Corporation throughout the years 1937, 1938, and 1939 had been engaged in the development of a chemical formula which was perfected and licensed for use in the industry in 1940, in which year the A Corporation derived royalties for the use of the formula in the sum of $150,000. The corporation did not in any of the four immediately preceding years derive any income in the nature of royalties. In such case the amount of $150,000 is, for excess profits tax purposes, attributable ratably to the years 1937, 1938, 1939, and 1940. Hence, of the amount of $150,000 three-fourths thereof, or $112,500, is excluded from gross income for the year 1940 in the computation of excess profits tax for that year. For method of computation of the excess profits tax for the year 1940, see the example in section 30.721–2.*

SEC. 30.721–5. *Change in accounting period or method of accounting.*—The fourth class of potentially abnormal income is income which is includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's accounting period or method of accounting. This class may include such items of income as are includible in gross income for the taxable year by reason of a change from the installment method to the straight accrual method of accounting, a change in inventory method, or a change from the reserve method to the specific charge-off method for the treatment of bad debts. Items of abnormal income includible in gross income for the taxable year rather than for a different taxable year by reason of a change from the installment method to the straight accrual method of accounting shall be attributed to the year or years such items accrued. The method of allocating items of abnormal income includible in gross income for the taxable year rather than for a different year by reason of other changes in accounting method or changes in accounting period is to be determined in each particular case upon consideration of all the facts in the case. (See section 30.721–1 as to the statement required to be filed where the benefits of section 721 are claimed.)

This section may be illustrated by the following example:

Example: The Y Corporation, prior to the calendar year 1940, reported its income on the installment basis. For the year 1940 it secures the consent of the Commissioner to a change in the method of reporting income to the straight accrual basis.

The gross income for the year 1940 computed under the straight accrual method of accounting and without regard to section 721 is as follows:

From installment sales contracts made in 1940	$320,000
From installment collections in 1940 on sales contracts made prior to 1940	250,000
From installment sales contracts made prior to 1940 but not yet collected	130,000
Total	700,000

Under the provisions of section 721, the $250,000 and $130,000 items are attributable for excess profits tax purposes to years prior to 1940, the amount attributable to each such year being equal to the amount includible in 1940 without regard to section 721 on account of contracts made in each such year. For method of computation of the excess profits tax for the year 1940, see the example in section 30.721–2.*

SEC. 30.721–6. *Income derived by lessor from termination of lease.*—The fifth class of potentially abnormal income is amounts included in gross income of a lessor for the taxable year by reason of the termination of the lease. Amounts may be required to be so included by reason of the fact that improvements made by the lessee upon the leased property come into the possession or control of the lessor upon termination or forfeiture of the lease. In such cases, if the income includible is abnormal either in kind or in amount, it shall be allocated in accordance with the following rules:

(*a*) If the lease has not been canceled or forfeited, but has merely expired, the income shall be spread over the life of the lease.

(*b*) If the lease has been canceled or forfeited, but the remaining useful life of the improvement is not in excess of what would have been the remaining life of the lease had the cancellation or forfeiture not occurred, the income shall be spread over what would have been the remaining life of the lease.

(c) If the lease has been canceled or forfeited and the remaining useful life of the improvement is in excess of what would have been the remaining life of the lease had the cancellation or forfeiture not occurred, then—

(1) An amount which bears the same ratio to the total income includible as the period which would have constituted the remaining life of the lease bears to the remaining useful life of the improvement shall be spread over what would have been the remaining life of the lease; and

(2) The remaining portion of the income includible shall be spread over the life of the lease, including what would have been its remaining life had the cancellation or forfeiture not occurred.

Amounts attributed to each future taxable year are to be included in gross income for such year for the purpose of computing the excess profits tax. This paragraph may be illustrated by the following example:

Example: On January 1, 1929, the A Corporation, which makes its income tax returns on the calendar year basis, leased to the X Corporation an unimproved site, on which the latter corporation completed a building on June 30, 1931. Such lease was for a period of 20 years and by its terms expired on December 31, 1948. On July 1, 1940, the lease is forfeited and the building comes into the possession and control of the A Corporation. The value as of such date of the building is $100,000, and its remaining useful life is 16 years. The A Corporation did not, prior to 1940, derive gross income of this nature nor did it report as gross income any amount with respect to the erection of the building. Since the remaining useful life of the improvement is 16 years but what would have been the remaining life of the lease is only $8\frac{1}{2}$ years, $\frac{8\frac{1}{2}}{16}$ of $100,000, or $53,125, is to be spread over what would have been the remaining life of the lease, *i. e.*, the last half of 1940, and the calendar years 1941 to 1948, both inclusive. Since there are 17 half years in such period, $\frac{1}{17}$ of $53,125, or $3,125, is to be allocated to the last half of 1940, and $\frac{2}{17}$ of $53,125, or $6,250, to each of the calendar years 1941 to 1948, both inclusive. The remainder of the $100,000 income, or $46,875 ($100,000 minus $53,125), is to be spread over the years 1929 to 1948, both inclusive, *i. e.*, $\frac{1}{20}$ of $46,875, or $2,343.75, is to be allocated to each such year. The total amount allocable to each year is as follows:

Years.	Amount per year.
1929–1939	$2,343.75
1940—	
Portion of $53,125 allocated to last half of year	3,125.00
Plus: Portion of $46,825 allocated to such year	2,343.75
Total	5,468.75
1941–1948—	
Portion of $53,125 allocated to each year	6,250.00
Plus: Portion of $46,825 allocated to each year	2,343.75
Total	8,593.75

The amounts allocated to the years 1929 to 1939, both inclusive, will have no effect upon the computation of the excess profits tax. The excess profits tax for the taxable year 1940 is to be determined by taking into gross income for such year only $5,468.75 of the $100,000 item otherwise includible. The amounts attributed to future years must be included in gross income for such years for the purpose of computing the excess profits tax.

Other income subject to the provisions of section 721 attributable to the termination of the lease is to be allocated as between the taxable year in which such income is realized and prior or subsequent taxable years in the light of the agreement underlying the realization of such income. If, for instance, the lessee pays the lessor a lump sum as consideration for cancellation of a lease, such lump sum, if found to be abnormal either in kind or in amount, shall be allocated ratably to the taxable years included in what would have been the remaining life of the lease had such lease not been canceled.*

SEC. 30.721-7. *Dividends on stock of foreign corporations other than foreign personal holding companies.*—The sixth and final class of potentially ab-

normal income under section 721 is dividends on stock of foreign corporations, except foreign personal holding companies. This section is applicable only to corporations electing the excess profits credit based on income, since section 711(a)(2)(A) gives corporations electing the excess profits credit based on invested capital a dividends received credit of 100 per cent of dividends of this class. In determining whether the receipt of such dividends is abnormal or whether the amount thereof is grossly disproportionate to the income of such class received in the four preceding taxable years, only dividends received from foreign corporations are to be taken into account. The exception relative to dividends from foreign personal holding companies applies both to distributions actually received from foreign personal holding companies and to constructive dividends deemed to have been received pursuant to section 337.

Income of this class which is abnormal either in kind or in amount is to be attributed to the years in which were accumulated the earnings and profits out of which such distributions were made, if accumulated after the acquisition by the distributee of the stock of the distributing corporation. If the earnings and profits out of which the distribution is made were accumulated prior to such acquisition, the income arising out of the distribution is to be attributed to the taxable year in which the stock was acquired. The earnings and profits out of which any distribution is made are, as provided in section 115, the most recently accumulated earnings and profits.

This section may be illustrated by the following example:

Example: The X Corporation, a domestic corporation, computing its excess profits credit on the income basis, acquired in 1938 all of the stock of the Y Company, Ltd., a foreign corporation, which is not a foreign personal holding company. The Y Company, Ltd., paid in July, 1940, a dividend to the X Corporation in the amount of $100,000. The X Corporation did not previously receive dividends from any foreign corporation. The Y Company, Ltd., had earnings and profits of $75,000 in 1940 and $125,000 in 1939. Following principles of existing law with respect to the source from which dividends are deemed to have been paid, the dividends received by the X Corporation in 1940 shall be allocated as between the years 1940 and 1939 in the respective sums of $75,000 and $25,000. See section 115(b) and corresponding provisions of prior revenue laws. For method of computation of the excess profits tax for the year 1940, see the example in section 30.721-2.*

"SEC. 722. ADJUSTMENT OF ABNORMALITIES IN INCOME AND CAPITAL BY THE COMMISSIONER.

"For the purposes of this subchapter, the Commissioner shall also have authority to make such adjustments as may be necessary to adjust abnormalities affecting income or capital, and his decision shall be subject to review by the United States Board of Tax Appeals."

SEC. 30.722-1. *Adjustment of abnormalities in income or capital.*—Under the provisions of section 722 the Commissioner is authorized to make such adjustments as may be found necessary by reason of abnormalities affecting income or capital. Adjustments for more than one abnormality may be necessary in a particular case. Abnormalities may require adjustments for the taxable year, or for one or more of the taxable years in the base period, or both. What adjustments are proper can be determined only upon consideration of all the facts in the particular case.

No general rule can be stated as to what constitutes an abnormality in either income or capital. The mere fact that the taxpayer derived an unusually high rate of profit on its invested capital is not sufficient to justify an adjustment.

A taxpayer claiming the benefits of section 722 shall, in making its excess profits tax return, compute and pay its excess profits tax without regard to section 722. In such case, the taxpayer should as promptly as possible file an application with the Commissioner of Internal Revenue, Washington, D. C., attention of the Income Tax Unit, Records Division, for relief under this section, showing the nature and extent of the alleged abnormalities in income or capital, the adjustments sought, and all the facts upon which it relies.*

"SEC. 723. EQUITY INVESTED CAPITAL IN SPECIAL CASES.

"Where the Commissioner determines that the equity invested capital as of the beginning of the taxpayer's first taxable year under this subchapter cannot be determined in accordance with section 718, the equity invested capital as of the beginning of such year shall be an amount

equal to the sum of (a) the money plus (b) the aggregate of the adjusted basis of the assets of the taxpayer held by the taxpayer at such time, such sum being reduced by the indebtedness outstanding at such time. The amount of the money, assets, and indebtedness at such time shall be determined in accordance with rules and regulations prescribed by the Commissioner with the approval of the Secretary. In such case, the equity invested capital for each day after the beginning of the taxpayer's first taxable year under this subchapter shall be determined, in accordance with rules and regulations prescribed by the Commissioner with the approval of the Secretary, using as the basic figure the equity invested capital as so determined."

SEC. 30.723-1. *Rules where equity invested capital can not be determined under section 718.*—In cases in which the Commissioner determines that the equity invested capital of a corporation as of the beginning of its first excess profits tax taxable year can not be determined in accordance with section 718, such equity invested capital shall be an amount equal to the sum of (*a*) the money, plus (*b*) the aggregate of the adjusted basis of the assets other than money, held by the corporation as of the beginning of such taxable year, such sum being reduced by the indebtedness of the corporation outstanding at such time. The adjusted basis of the assets shall be the adjusted basis for determining loss upon a sale or exchange for Federal income tax purposes. See, in general, section 113 and the regulations prescribed thereunder. For the purposes of section 723 the term "indebtedness" means any liability of the corporation, absolute and not contingent, and includes liabilities assumed by the corporation, whether or not in connection with property held by the taxpayer, and any liabilities to which property held by the corporation is subject, but does not include the obligation of the corporation on its capital stock.

The equity invested capital under section 723 for each day after the first day of the first excess profits tax taxable year of the corporation shall be the basic figure determined under the first paragraph of this section increased or decreased as provided in section 718 and the regulations prescribed thereunder with respect to changes in the equity invested capital occurring after the beginning of such first taxable year. For such purpose the term "accumulated earnings and profits" means the earnings and profits accumulated since the beginning of the first excess profits tax taxable year of the corporation, computed without regard to any deficit in accumulated earnings and profits existing at the beginning of such year. Similarly, the term "earnings and profits" refers only to such accumulated earnings and profits and earnings and profits of an excess profits tax taxable year. In all cases coming under section 723 the taxpayer shall be treated as a corporation newly organized immediately prior to the beginning of its first excess profits tax taxable year with an equity invested capital, consisting of money paid in for stock, equal to the basic figure determined under section 723.

In any case in which a taxpayer finds it impossible to determine its equity invested capital as of the beginning of its first excess profits tax taxable year in accordance with section 718, it may compute its equity invested capital in accordance with section 723, provided it submits with its return a schedule showing such computation, and a statement of the facts upon which it bases its conclusion that it can not compute its equity invested capital under section 718, so that the Commissioner may determine whether its equity invested capital can be computed in accordance with that section.*

"SEC. 724. FOREIGN CORPORATIONS AND CORPORATIONS ENTITLED TO BENEFITS OF SECTION 251—INVESTED CAPITAL.

"Notwithstanding section 715, 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, and in the case of a corporation entitled to the benefits of section 251, the invested capital for any taxable year shall be determined in accordance with rules and regulations prescribed by the Commissioner with the approval of the Secretary, under which—

"(a) GENERAL RULE.—The daily invested capital for any day of the taxable year shall be the aggregate of the adjusted basis of each United States asset held by the taxpayer on the beginning of such day. In the application of section 720 in reduction of the average invested capital (determined on the basis of such daily invested capital), the terms

'admissible assets' and 'inadmissible assets' shall include only United States assets; or

"(b) EXCEPTION.—If the Commissioner determines that the United States assets of the taxpayer cannot satisfactorily be segregated from its other assets, the invested capital for the taxable year shall be an amount which is the same percentage of the aggregate of the adjusted basis of all assets held by the taxpayer as of the end of the last day of the taxable year which the net income for the taxable year from sources within the United States is of the total net income of the taxpayer for such year.

"(c) DEFINITION OF UNITED STATES ASSET.—As used in this subsection, the term 'United States asset' means an asset held by the taxpayer in the United States, determined in accordance with rules and regulations prescribed by the Commissioner with the approval of the Secretary."

SEC. 30.724–1. *Invested capital of certain foreign corporations and corporations entitled to benefits of section 251.*—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, and in the case of a corporation entitled to the benefits of section 251 (on account of deriving a large portion of its gross income from possessions of the United States), the invested capital for any taxable year shall be invested capital as provided in sections 715, 716, 717, and 720, with the following exceptions:

(*a*) The daily invested capital for each day in the taxable year shall be the aggregate of the adjusted basis of each United States asset as defined in (*d*) below held by the taxpayer on the beginning of such day. The adjusted basis of each such asset shall be the adjusted basis for determining loss upon a sale or exchange for Federal income tax purposes. The amount of United States assets held at the beginning of each day of the taxable year shall be determined in the same manner as the amount of admissible and inadmissible assets is determined under section 30.720–1. The daily invested capital computed under this section is not affected by the indebtedness of the corporation, and does not include borrowed capital as defined in section 719.

(*b*) In the application of section 720 in reduction of the average invested capital (determined on the basis of the daily invested capital as provided in (*a*) above), the terms "admissible assets" and "inadmissible assets" shall include only United States assets. The amount of such admissible assets and inadmissible assets shall be determined in the same manner as provided in section 30.720–1.

(*c*) In cases in which the Commissioner determines that the United States assets of a corporation can not satisfactorily be segregated from its other assets, the invested capital of the corporation for the taxable year shall be an amount which is the same percentage of the aggregate adjusted basis (for determining loss) of all assets held by the taxpayer as of the end of the last day of the taxable year which the net income for the taxable year from sources within the United States is of the total net income of the taxpayer for such year. For the purposes of this paragraph the net income of the corporation from sources within the United States shall be determined as provided in section 119 and the regulations prescribed thereunder. The provisions of sections 715 and 720 relating to adjustment for inadmissible assets have no application in determining invested capital under section 724(b).

(*d*) For the purposes of section 724 the term "United States asset" means an asset either (1) employed by the taxpayer in the United States in carrying on its trade or business therein, or (2) of a kind the income from which is income from sources within the United States under section 119 and the regulations prescribed thereunder irrespective of where the evidence of the property right in such asset is held.*

"SEC. 725. PERSONAL SERVICE CORPORATIONS.

"(a) DEFINITION.—As used in this subchapter, the term 'personal service corporation' means a corporation whose income is to be ascribed primarily to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation and are the owners at all times during the taxable year of at least 70 per centum in value of each class of stock of the corporation, and in which capital is not a material income-producing factor; but does not include any foreign

corporation, nor any corporation 50 per centum or more of whose gross income consists of gains, profits, or income derived from trading as a principal. For the purposes of this subsection, an individual shall be considered as owning, at any time, the stock owned at such time by his spouse or minor child or by any guardian or trustee representing them.

"(b) ELECTION AS TO TAXABILITY.—If a personal service corporation signifies, in its return under Chapter 1 for any taxable year, its desire not to be subject to the tax imposed under this subchapter for such taxable year, it shall be exempt from such tax for such year, and the provisions of Supplement S of Chapter 1 shall apply to the shareholders in such corporation who were such shareholders on the last day of such taxable year of the corporation."

SEC. 30.725–1. *Taxation of personal service corporations.*—A personal service corporation is subject to the excess profits tax imposed under Subchapter E of Chapter 2 the same as any other domestic corporation unless it elects as to any taxable year not to be subject to such tax. If the corporation elects not to be subject to the excess profits tax, the provisions of Supplement S (sections 391 to 396, inclusive, as added by section 502 of the Second Revenue Act of 1940) shall apply to the shareholders in such corporation who were such shareholders on the last day of the taxable year of the corporation. See section 19.394–1 of Regulations 103. In such case, the amount of the undistributed Supplement S net income shall be considered as paid in to the corporation as of the close of the taxable year as paid-in surplus or as a contribution to capital, and the amount of accumulated earnings and profits as of the close of such year shall be correspondingly reduced. See section 394(d).*

SEC. 30.725–2. *Definition of personal service corporation.*—(*a*) *In general.*—The term "personal service corporation" means a domestic corporation in which capital is not a material income-producing factor and the income of which is to be ascribed primarily to the activities of shareholders who (1) are regularly engaged in the active conduct of the affairs of the corporation, and (2) are the owners, throughout the entire taxable year, of at least 70 per cent in value of each class of stock of the corporation.

If 50 per cent or more of the gross income of a corporation consists of gains, profits, or income derived from trading as a principal, such corporation can not be considered to be a personal service corporation. As to corporations in which less than 50 per cent of the gross income is derived from trading as a principal, see (*c*) below.

(*b*) *Stock interest of shareholders.*—Shareholders regularly engaged in the active conduct of the affairs of the corporation and to whom the income of the corporation is primarily to be ascribed must own at all times during the taxable year at least 70 per cent in value of each class of stock of the corporation. If stock is owned by the spouse or minor child of an individual, or owned by the guardian or trustee of such spouse or child, such stock is treated as being owned by such individual.

A corporation can not be considered to be a personal service corporation for any taxable year if another corporation owns more than 30 per cent in value of any class of its stock at any time during such year. A corporation is an artificial entity and can not itself be regularly engaged in the active conduct of the affairs of another corporation within the meaning of section 725.

The fact that the ownership of shares in the corporation may change during the course of the taxable year does not take the corporation which is otherwise a personal service corporation out of that class unless at some time during the taxable year the ownership of more than 30 per cent in value of the shares of any class of stock passes into the hands of persons not regularly engaged in the active conduct of the affairs of the corporation.

(*c*) *Income to be ascribed primarily to the activities of shareholders.*—If employees other than shareholders contribute substantially to the services rendered by a corporation, such corporation is not a personal service corporation unless, in every case in which services are so rendered, the value of and the compensation charged for such services are to be attributed primarily to the experience or skill of the shareholders and such fact is evidenced in some definite manner in the normal course of the business or profession. The fact that the shareholders give personal attention or render valuable services to the corporation as a result of which its earnings are greater than those of a corporation engaged

in a like or similar business or profession, the shareholders of which are not regularly engaged in the activities of the corporation, does not of itself constitute the corporation a personal service corporation.

Income of a corporation from merchandising or trading as a principal, directly or indirectly, in commodities or in the services of others is not to be ascribed primarily to the activities of its shareholders. Income of a corporation from the conduct of an auction, agency, brokerage, or commission business strictly on the basis of a fee or commission may be so ascribed. If, however, either as a matter of business policy or by contract, the corporation assumes any such risks as those of market fluctuations, bad debts, or failure to accept shipments, or if it guarantees the accounts of the purchaser or is in any way accountable to the seller for the payment of the purchase price, the transaction is one of merchandising or trading, and this is true even though the goods are shipped directly from the producer to the consumer and are never actually in the possession of the corporation. The fact that earnings of the corporation are termed commissions or fees is not controlling. The fact that a commission or fee in a transaction is based on a difference in the prices at which the seller sells and the buyer buys raises a presumption that the transaction is one of merchandising or trading, and it will be so considered in the absence of satisfactory evidence to the contrary.

It may happen that a corporation is engaged in two or more businesses or professions which are more or less related. Thus, an engineering concern may also engage in contracting, which amounts to trading in materials and labor, or a brokerage concern may guarantee some of its accounts, or a photographic concern may sell pictures, frames, art goods, and supplies. In such cases, the corporation is not a personal service corporation unless the activities of the corporation consisting of trading or guaranteeing of accounts or selling are negligible or merely incidental, and unless no appreciable part of the earnings is to be ascribed to such activities. See also (*c*) below relating to the employment of capital.

(*d*) *Shareholders regularly engaged in the active conduct of the affairs of the corporation.*—A corporation is not a personal service corporation unless shareholders who own at all times during the taxable year at least 70 per cent in value of each class of stock are regularly engaged in the active conduct of the affairs of the corporation. That such shareholders devote some of their time to the affairs of the corporation is not sufficient; they must with regularity devote substantial time and energy to the conduct of its affairs.

(*e*) *Capital as a material income-producing factor.*—In a personal service corporation capital must not be a material income-producing factor. Whether capital is a material income-producing factor is to be determined by reference to (1) the extent to which capital is required to carry on the business or profession, and (2) the extent to which capital is actually used in the production of income though not required by the primary activities of the corporation. If the use of capital is necessary to the production of the income of the corporation and is more than incidental, capital is a material income-producing factor and the corporation is not a personal service corporation. If a substantial portion of the income is attributable to a use of capital, whether or not connected with the primary activities of the corporation, capital is a material income-producing factor even though such use of capital is not necessary to such primary activities. The term "capital" as used in section 725 and in this section means not only capital actually invested by the shareholders but also capital obtained in other ways. Thus, capital may be borrowed either directly as shown by bonds, debentures, certificates of indebtedness, notes, bills payable, or other paper, or indirectly as shown by accounts payable or other forms of credit, or the business of the corporation may be financed in some other manner by its shareholders. If a substantial amount of capital is used to finance or carry the accounts of clients or customers, it will be inferred that because of competition or for other reasons such use of capital is necessary and more than incidental in order to secure or hold business which would otherwise be lost. If a corporation engaged in an agency, brokerage, or commission business regularly employs a substantial amount of capital to lend to its principals, to buy and carry goods on its own account, or to buy and carry odd lots in order that it may render more satisfactory service to its principals or customers, such corporation is not a personal service corporation. In general, the larger the amount of capital actually used the stronger is the evidence

that capital is necessary and more than incidental and is a material income-producing factor.

The term "income" as used in section 725 and in this section means gross income. Capital is a material income-producing factor if its use results in a substantial amount of gross income, irrespective of the amount of net income, if any, such use produces.

(*f*) *Application of regulations; returns.*—No definite and conclusive tests can be prescribed by which it can be finally determined in advance of an examination of the corporation's income tax return whether it is or is not a personal service corporation. In the preceding subsections are set forth the general principles under which such determination will be made.

If a corporation claiming to be a personal service corporation signifies in its return under Chapter 1 for any taxable year its desire not to be subject to the excess profits tax under Subchapter E of Chapter 2 for such taxable year, it shall attach Form 1121PS, in duplicate, to its income tax return on Form 1120. In Form 1121PS there shall be stated (1) such facts as tend to show whether or not the corporation is a personal service corporation, including (i) the nature of its business, (ii) the character, preferences, dividend rates, and other essential features of the various classes of its stock outstanding for any time during the taxable year, (iii) the names and addresses of its several shareholders and their relationship to each other, (iv) the number and classes of shares owned at any time during the taxable year by each shareholder and the portion of the year during which such shares were so owned, (v) the nature of the activities of the several shareholders on behalf of the corporation, and (vi) the extent to which capital in any form is used in the business, and (2) the computation of the undistributed Supplement S net income for the taxable year, the names and addresses of all shareholders of the corporation at the close of the taxable year, the number and classes of shares held by each, and such other information as may be required by the form and the instructions printed on the form or issued therewith.*

SEC. 30.725-3. *Election as to taxability.*—The election as to taxability provided for in section 725(b) and the resulting exemption from tax have application only to the excess profits tax on domestic corporations imposed under Subchapter E of Chapter 2 as added by section 201 of the Second Revenue Act of 1940. The corporation may make such an election by signifying in its return under Chapter 1 its desire not to be subject to the excess profits tax. A new election is required for each taxable year. An amended return filed after the statutory period for filing the return (or after the last day of any extension period) is not a return within the meaning of section 725(b).

A domestic corporation which elects in its income tax return for a taxable year to be exempt from the excess profits tax for such year as a personal service corporation may, notwithstanding such election, file an excess profits tax return for such taxable year on Form 1121. Such return shall be complete in all respects except for the computation of the tax, and there shall be attached to it a statement that the corporation desires to be classified as a personal service corporation and not to be subject to the excess profits tax for the taxable year and that it has attached Form 1121PS in duplicate to its income tax return on Form 1120. An excess profits tax return made in this manner within the time prescribed by law will constitute a return within the meaning of section 712(a). In the case of a domestic corporation which files such a return electing therein as provided in section 712(a) or section 741 to compute its excess profits credit for such taxable year under section 713 or section 714 and which is subsequently determined not to be a personal service corporation, the amount of excess profits tax for such year shall be determined by the Commissioner in accordance with the election so made by the corporation with respect to the computation of its excess profits credit, and the excess profits tax so determined will constitute a deficiency which shall be assessed and collected in the same manner as in the case of a deficiency in income tax under Chapter 1. A corporation not filing an excess profits tax return for a taxable year within the time prescribed by law may not in any case elect to have the excess profits credit for such taxable year computed under section 713. The allowance of a credit or refund of any income tax overpaid by the shareholders of a corporation denied personal service classification is subject to the limitations provided in section 322.*

"SEC. 726. CORPORATIONS COMPLETING CONTRACTS UNDER MERCHANT MARINE ACT, 1936.

"(a) If the United States Maritime Commission certifies to the Commissioner that the taxpayer has completed within the taxable year any contracts or subcontracts which are subject to the provisions of section 505(b) of the Merchant Marine Act of 1936, as amended, then the tax imposed by this subchapter for such taxable year shall be, in lieu of a tax computed under section 710, a tax computed under subsection (b) of this section, if, and only if, the tax computed under subsection (b) is less than the tax computed under section 710.

"(b) The tax computed under this subsection shall be the excess of—

"(1) A tentative tax computed under section 710 with the normal-tax net income increased by the amount of any payments made, or to be made, to the United States Maritime Commission with respect to such contracts or subcontracts; over

"(2) The amount of such payments."

SEC. 30.726–1. *Corporations completing contracts under Merchant Marine Act of 1936.*—(*a*) Section 726 provides for an alternative tax in the case of a corporation which has been certified by the United States Maritime Commission (hereinafter referred to as the Commission) to the Commissioner as having completed within the taxable year any contracts or subcontracts subject to the provisions of section 505(b) of the Merchant Marine Act of 1936, as amended (hereinafter referred to as section 505(b)). Under section 505(b) a contractor or subcontractor is required to pay to the Commission the amount of profit, if any, in excess of 10 per cent of the total contract prices of such contracts or subcontracts.

(*b*) The alternative tax is in lieu of the excess profits tax computed under section 710 but only if such alternative tax is less than the tax under such section. Such alternative tax is the excess of (1) a tentative tax computed under section 710 with the normal-tax net income increased by the amount of any payments made, or to be made, to the Commission with respect to contracts or subcontracts the completion of which during the taxable year has been certified to the Commissioner by the Commission, over (2) the amount of such payments.

(*c*) For the purposes of section 726, a certificate by the Commission that the vessel or portion thereof covered by the contract or subcontract has been delivered during the taxable year shall be deemed to be the certificate required by such section.

(*d*) A corporation claiming the benefit of section 726 shall attach to its excess profits tax return (1) a certificate of the Commission showing each contract or subcontract subject to the provisions of section 505(b) which the corporation has completed within the taxable year and (2) a statement showing the amount of payments made, or to be made, to the Commission with respect to such contracts and subcontracts. If the amount of the payments made, or to be made, to the Commission with respect to such contracts or subcontracts has not been ascertained at the time of filing the excess profits tax return the coroporation may estimate the amount of such payments for the purposes of section 726. In such cases, the Commissioner may require a bond from the corporation as a condition precedent to the computation of the tax under that section. If such a bond is required it shall be on the form prescribed by the Commissioner and in such sum as the Commissioner may prescribe, and it shall be conditioned upon the payment by the corporation of any amount of tax found due upon redetermination of the tax made necessary by the estimated amount under section 726(b)(2) proving incorrect, and upon such further conditions as the Commissioner may require. The bond shall be executed by the corporation as principal and by sureties satisfactory to the Commissioner. (See also section 1126 of the Revenue Act of 1926, as amended, paragraph 63 of the Appendix to Regulations 103.)

(*e*) If the amount actually paid, or to be paid, to the Commission under section 505(b) differs from the amount used in determining the tax under section 726, the corporation shall immediately notify the Commissioner of the amount actually paid, or to be paid, with respect to the particular contract. The Commissioner will thereupon redetermine the amount of the excess profits tax under section 726 and the amount of tax, if any, found to be due upon such redetermination shall be paid by the corporation upon notice and demand from

he collector. The amount of tax, if any, shown upon redetermination to have een overpaid shall be credited or refunded to the taxpayer in accordance with he provisions of section 322.*

"SEC. 727. EXEMPT CORPORATIONS.

"The following corporations shall be exempt from the tax imposed by this subchapter:

"(a) Corporations exempt under section 101 from the tax imposed by Chapter 1.

"(b) Foreign personal-holding companies, as defined in section 331.

"(c) Mutual investment companies, as defined in section 361.

"(d) Investment companies which under the Investment Company Act of 1940 are registered as diversified companies at all times during the taxable year. For the purposes of this subsection, if a company is so registered before July 1, 1941, it shall be considered as so registered at all times prior to the date of such registration.

"(e) Personal-holding companies, as defined in section 501.

"(f) Foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein.

"(g) Domestic corporations satisfying the following conditions:

"(1) If 95 per centum or more of the gross income of such domestic corporation for the three-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) was derived from sources other than sources within the United States; and

"(2) If 50 per centum or more of its gross income for such period or such part thereof was derived from the active conduct of a trade or business.

"(h) Any corporation subject to the provisions of Title IV of the Civil Aeronautics Act of 1938, in the gross income of which for any taxable year beginning after December 31, 1939, there is includible compensation received from the United States for the transportation of mail by aircraft if, after excluding from its gross income such compensation, its adjusted excess profits net income for such year is zero or less."

SEC. 30.727-1. *Exempt corporations.*—(*a*) A corporation which has established ts right under section 101 to exemption from income tax need not again stablish its right under section 727(a) to exemption from excess profits tax. corporation which has not established its right to exemption under section 01 and which claims exemption under section 727(a) is required to establish ts right to exemption under section 101 in the manner prescribed in the egulations thereunder in order to be held exempt under section 727(a).

(*b*) A corporation which claims exemption under the provisions of section 727, ther than the provisions of section 727 (a), (g), and (h), shall file with its ncome tax return a statement showing under what paragraph of section 727 claim exemption.

(*c*) A corporation which claims exemption under section 727(g) shall attach o its income tax return a statement showing for the 3-year period immediately receding the close of the taxable year (or for such part thereof during which he corporation was in existence) (1) its total gross income from all sources, 2) the amount thereof derived from the active conduct of a trade or business, 3) a description of such trade or business and the facts upon which the orporation relies to establish that such trade or business was actively conucted by it, and (4) the amount of its gross income from sources within he United States. The gross income from sources within the United States hall be determined as provided in section 119 and the regulations prescribed hereunder.

(*d*) A corporation which claims exemption under section 727(h) shall attach o its income tax return a statement showing (1) that it is subject to the proisions of Title IV of the Civil Aeronautics Acts of 1938, (2) the amount of the ompensation included in the gross income of the corporation as compensation eceived from the United States for the transportation of mail by aircraft, and 3) the amount of its gross income, net income, excess profits net income, and djusted excess profits net income, after excluding from its gross income the mount of such compensation.

As to the statute of limitations where no return is filed, see sections 275(a) nd 276(a).*

"SEC. 728. MEANING OF TERMS USED.

"The terms used in this subchapter shall have the same meaning as when used in Chapter 1.

"SEC. 729. LAWS APPLICABLE.

"(a) GENERAL RULE.—All provisions of law (including penalties) applicable in respect of the taxes imposed by Chapter 1, shall, insofar as not inconsistent with this subchapter, be applicable in respect of the tax imposed by this subchapter.

"(b) RETURNS.—Notwithstanding subsection (a), no return under section 52(a) shall be required to be filed by any taxpayer under this subchapter for any taxable year for which its excess profits net income, computed with the adjustments provided in section 711(a)(2) and placed on an annual basis as provided in section 711(a)(3), is not greater than $5,000.

"(c) FOREIGN TAXES PAID.—In the application of section 131 for the purposes of this subchapter the tax paid or accrued to any country shall be deemed to be the amount of such tax reduced by the amount of the credit allowed with respect to such tax against the tax imposed by Chapter 1.

"(d) LIMITATIONS ON AMOUNT OF FOREIGN TAX CREDIT.—The amount of the credit taken under this section shall be subject to each of the following limitations:

"(1) The amount of the credit in respect of the tax paid or accrued to any country shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's excess profits net income from sources within such country bears to its entire excess profits net income for the same taxable year; and

"(2) The total amount of the credit shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's excess profits net income from sources without the United States bears to its entire excess profits net income for the same taxable year."

SEC. 30.729–1. *Time and place for filing returns.*—Excess profits tax returns shall be filed at the same time and place as the time and place prescribed in sections 53 and 235 and the income tax regulations under such sections for the filing of income tax returns, except that such excess profits tax returns for taxable years ending before December 31, 1940, which, if filed within the time prescribed in such regulations, would be filed before March 15, 1941, shall be filed on or before March 15, 1941. The excess profits tax return of a corporation of income received or accrued from the date of its incorporation to the end of its first accounting period, where the period between the date of incorporation and the end of such period is less than 12 months, shall be considered as a return for a fractional part of a year, and shall be filed within the time prescribed for filing returns for taxable years of less than 12 months.*

SEC. 30.729–2. *Time for payment of tax.*—The excess profits tax shall be paid at the same time as the time prescribed in sections 56 and 236 and the income tax regulations under such sections for the payment of income tax, except that such excess profits tax for taxable years ending before December 31, 1940, which, if paid within the time so prescribed, would be paid before March 15, 1941, shall be paid on or before March 15, 1941. In case an election is made to pay in installments such excess profits tax for a taxable year ending before December 31, 1940, and the first installment, if paid within the time prescribed in such regulations, would be paid before March 15, 1941, then the first installment of such tax shall be paid on March 15, 1941, and the second, third, and fourth installments thereof shall be paid on or before the 15th day of the third, sixth, and ninth month, respectively, after March 15, 1941.*

SEC. 30.729–3. *Foreign tax credit.*—The provisions of law made applicable to the excess profits tax by section 729(a) include section 131 relating to the credit for income, war-profits and excess-profits taxes paid or accrued during the taxable year to any foreign country or any possession of the United States. The taxpayer is allowed such a credit against the excess profits tax if it claims such credit in its Federal income tax return and likewise claims such credit in its excess profits tax return. The amount of such credit allowable against the excess profits tax is (*a*) the amount of such income, war-profits,

and excess-profits taxes reduced by (*b*) the amount of such taxes allowed as a credit under section 131 against the income tax. Thus, for instance, if a taxpayer pays to a foreign country with respect to the calendar year 1940 income tax in the amount of $25,000 upon income from sources therein and, due to the operation of the limitation provisions contained in section 131(b), only the amount of $20,000 is allowed as a credit against the income tax for that year, the remainder, or $5,000, is available as a credit against the excess profits tax for the year 1940. The amount thus made available as a credit against the excess profits tax is, however, subject to the further limitations provided in section 729(d). For the application of the limitations provided in section 729(d) to the amount of income, war-profits or excess-profits taxes thus made available as a credit against the excess profits tax, see section 131(b) and the regulations prescribed thereunder."

"SEC. 730. CONSOLIDATED RETURNS.

"(a) PRIVILEGE TO FILE CONSOLIDATED RETURNS.—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all the corporations which have been members of the affiliated group at any time during the taxable year for which the return is made consent to all the regulations under subsection (b) prescribed prior to the last day prescribed by law for the filing of such return; and the making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

"(b) REGULATIONS.—The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the excess profits tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

"(c) COMPUTATION AND PAYMENT OF TAX.—In any case in which a consolidated return is made the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under subsection (b) prescribed prior to the last day prescribed by law for the filing of such return. Only one specific exemption of $5,000 provided in section 710(b)(1) shall be allowed for the entire affiliated group of corporations.

"(d) DEFINITION OF 'AFFILIATED GROUP'.—As used in this section, an 'affiliated group' means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

"(1) At least 95 per centum of each class of the stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

"(2) The common parent corporation owns directly at least 95 per centum of each class of the stock of at least one of the other includible corporations.

As used in this subsection, the term 'stock' does not include nonvoting stock which is limited and preferred to as to dividends.

"(e) DEFINITION OF 'INCLUDIBLE CORPORATION'.—As used in this section, the term 'includible corporation' means any corporation except—

"(1) Corporations exempt from the tax imposed by this subchapter.

"(2) Foreign corporations.

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

"(4) Corporations entitled to the benefits of section 251, by reason of receiving a large percentage of their income from possessions of the United States.

"(5) Personal service corporations.

"(6) Insurance companies subject to taxation under section 201, 204, or 207.

"(f) INCLUDIBLE INSURANCE COMPANIES.—Despite the provisions of paragraph (6) of subsection (e), two or more domestic insurance companies each of which is subject to taxation under the same section of Chapter 1 shall be considered as includible corporations for the purpose of the application of subsection (d) to such insurance companies alone.

"(g) SUBSIDIARY FORMED TO COMPLY WITH FOREIGN LAW.—In the case of a domestic corporation owning or controlling, directly or indirectly, 100 per centum of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for the purpose of this subchapter as a domestic corporation.

"(h) SUSPENSION OF RUNNING OF STATUTE OF LIMITATIONS.—If a notice under section 272(a) in respect of a deficiency for any taxable year is mailed to a corporation, the suspension of the running of the statute of limitations, provided in section 277, shall apply in the case of corporations with which such corporation made a consolidated return for such taxable year."

SEC. 30.730–1. *Consolidated excess profits tax returns of affiliated corporations.*—Regulations prescribed under section 730(b) as a separate Treasury decision are applicable to the making of consolidated excess profits tax returns by affiliated corporations for taxable years beginning after December 31, 1939, and to the determination, computation, assessment, collection, and adjustment of tax liabilities under consolidated returns for such years. For definition of taxable year, see section 48.*

SEC. 30.732–2. *Formation of and changes in affiliated group.*—An affiliated group of corporations, within the meaning of section 730, is formed at the time that the common parent corporation which is an includible corporation becomes the owner directly of at least 95 per cent of each class of the stock of another includible corporation. A corporation becomes a member of such an affiliated group at the time that one or more members of such group become the owners directly of at least 95 per cent of each class of its stock. A corporation ceases to be a member of such an affiliated group at the time that the aggregate of each class of its stock owned directly by the members of such group becomes less than 95 per cent. The term "stock" as herein used does not include nonvoting stock which is limited and preferred as to dividends.*

SEC. 30.730–3. *Corporations to be included in consolidated excess profits tax returns.*—The privilege of filing consolidated excess profits tax returns is limited to corporations constituting an "affiliated group" as defined in section 730(d). A consolidated return must include every domestic corporation which is a member of the "affiliated group" but shall not include a corporation which is not an "includible" corporation as defined in section 739(e). In no case may a consolidated return be filed by subsidiary corporations as an affiliated group unless the common parent corporation through which the subsidiaries are connected is a member of the group. For instance, there will not be recognized as an affiliated group two industrial corporations the common parent corporation of which is an insurance company or a personal holding company. In addition, no corporation which is connected by stock ownership with an affiliated group of includible corporations through a nonincludible corporation may be included in a consolidated return.

While insurance companies are not includible in an affiliated group of corporations which are not insurance companies, an insurance company may be affiliated with other insurance companies subject to the income tax imposed by the same section. For example, an insurance company taxable under section 201 may be affiliated with another insurance company taxable under section 201 but not with an insurance company taxable under section 204 or section 207.*

SEC. 30.730–4. *Foreign corporations which may be treated as domestic corporations.*—In the case of a domestic corporation owning or controlling, directly or indirectly, the entire capital stock (exclusive of directors' qualifying shares)

a corporation organized under the laws of Canada or of Mexico and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated as a domestic corporation. The option to treat such foreign corporation as a domestic corporation must be exercised at the time making the first consolidated excess profits tax return, and can not be exercised at any time thereafter. If the election is exercised to treat such foreign corporation as a domestic corporation it must be included in the consolidated return of the affiliated group of which it is a member for each year for which such group makes or is required to make a consolidated return.*

"SEC. 731. CORPORATIONS ENGAGED IN MINING OF STRATEGIC METALS.

"In the case of any domestic corporation engaged in the mining of tungsten, quicksilver, manganese, platinum, antimony, chromite, or tin, the portion of the adjusted excess profits net income attributable to such mining in the United States shall be exempt from the tax imposed by this subchapter. The tax on the remaining portion of such adjusted excess profits net income shall be an amount which bears the same ratio to the tax computed without regard to this section as such remaining portion bears to the entire adjusted excess profits net income."

SEC. 30.731-1. *Corporations which mine strategic metals.*—(*a*) If a domestic corporation is engaged in mining tungsten, quicksilver, manganese, platinum, antimony, chromite, or tin (hereinafter referred to as strategic metals), within the United States, the portion of its adjusted excess profits net income attributable to such mining is exempt from the excess profits tax. The excess profits tax on the remaining portion of such adjusted excess profits net income is an amount which bears the same ratio to the excess profits tax computed without regard to section 731 as such remaining portion bears to the entire adjusted excess profits net income.

(*b*) The portion of the adjusted excess profits net income attributable to mining of strategic metals is an amount which bears the same ratio to the total adjusted excess profits net income as the portion of the excess profits net income attributable to such mining bears to the total excess profits net income. The portion of the excess profits net income attributable to such mining is the gross income derived from strategic metals and arising out of operations which give rise to "gross income from the property," as defined in section 23.23 (m)-(1) (*f*) of Regulations 103, less the sum of (1) allowable deductions which are directly attributable to such mining, (2) any adjustments made under section 711 involving items directly attributable to such mining, and (3) an allocable portion of any deductions partly attributable to such mining and of any adjustments under section 711 involving items partly attributable to such mining.

(*c*) There shall be attached to and made a part of the return of any taxpayer claiming the benefits under section 731 a schedule containing the following information:

(1) The amount of gross income from the mining of strategic metals and from each other activity of the corporation;

(2) The allowable deductions and the adjustments under section 711 directly attributable to such mining; and

(3) The portion of the allowable deductions and of the adjustments under section 711 allocated to such mining and the basis for such allocation.

The following example illustrates the computation of the tax in the case of a corporation entitled to the benefits of section 731:

Example: The M Corporation, a domestic corporation, mines both gold and platinum (a by-product of gold) and reduces the ores containing such metals. The corporation has an excess profits credit of $40,000. The excess profits net income attributable to platinum mining is $20,000; that attributable to other activities is $95,000. The tax is $17,347.83, computed as follows:

(a) Total excess profits net income		$115,000.00
(b) Less:		
Specific exemption	$5,000	
Excess profits credit	40,000	
		45,000.00
(c) Total adjusted excess profits net income		70,000.00

(4) Less:		
Portion attributable to platinum mining $\left(\frac{20,000}{115,000}\text{ of }\$70,000\right)$		$12,173.91
(5) Remaining portion of adjusted excess profits net income		57,826.09
(6) Tax on adjusted excess profits net income of $70,000 computed without regard to section 731 (see section 710)		21,000.00
(7) Tax under section 731 on item (5), *i. e.*, portion of item (6) which bears the same ratio to $21,000 as portion of adjusted excess profits net income not attributable to platinum mining bears to total adjusted excess profits net income $\left(\frac{57,826.09}{70,000}\text{ of }\$21,000\right)$		17,347.83

"PART II—RULES IN CONNECTION WITH CERTAIN EXCHANGES.

"Supplement A—Excess Profits Credit Based on Income.

"SEC. 740. DEFINITIONS.

"For the purposes of this Supplement—

"(a) ACQUIRING CORPORATION.—The term 'acquiring corporation' means—

"(1) A corporation which has acquired—

"(A) substantially all the properties of another corporation and the whole or a part of the consideration for the transfer of such properties is the transfer to such other corporation of all the stock of all classes (except qualifying shares) of the corporation which has acquired such properties, or

"(B) substantially all the properties of another corporation and the sole consideration for the transfer of such properties is the transfer to such other corporation of voting stock of the corporation which has acquired such properties, or

"(C) before October 1, 1940, properties of another corporation solely as paid-in surplus or a contribution to capital in respect of voting stock owned by such other corporation.

For the purposes of subparagraphs (B) and (C) in determining whether such voting stock or such paid-in surplus or contribution to capital is the sole consideration, the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded. Subparagraph (B) or (C) shall apply only if the corporation transferring such properties is forthwith completely liquidated in pursuance of the plan under which the acquisition is made, and the transaction of which the acquisition is a part has the effect of a statutory merger or consolidation.

"(2) A corporation which has acquired property from another corporation in a transaction with respect to which gain or loss was not recognized under section 112(b) (6) of Chapter 1 or a corresponding provision of a prior revenue law;

"(3) A corporation the result of a statutory merger of two or more corporations; or

"(4) A corporation the result of a statutory consolidation of two or more corporations.

"(b) COMPONENT CORPORATION.—The term 'component corporation' means—

"(1) In the case of a transaction described in subsection (a)(1), the corporation which transferred the assets;

"(2) In the case of a transaction described in subsection (a)(2),

"(3) In the case of a statutory merger, all corporations merged, the corporation the property of which was acquired;

except the corporation resulting from the merger; or

"(4) In the case of a statutory consolidation, all corporations consolidated, except the corporation resulting from the consolidation.

"(c) QUALIFIED COMPONENT CORPORATION.—The term 'qualified component corporation' means a component corporation which was in existence on the date of the beginning of the taxpayer's base period.

"(d) BASE PERIOD.—In the case of a taxpayer which is an acquiring corporation the base period shall be:

"(1) If the tax is being computed for any taxable year beginning in 1940, the forty-eight months preceding the beginning of such taxable year; or

"(2) If the tax is being computed for any taxable year beginning after December 31, 1940, the forty-eight months preceding what would have been its first taxable year beginning in 1940 if it had had a taxable year beginning in 1940 on the date on which the taxable year for which the tax is being computed began.

"(e) BASE PERIOD YEARS.—In the case of a taxpayer which is an acquiring corporation its base period years shall be the four successive twelve-month periods beginning on the same date as the beginning of its base period.

"(f) EXISTENCE OF ACQUIRING CORPORATION.—For the purposes of subsection (c) and section 741, if any component corporation was in existence on the date of the beginning of the taxpayer's base period (either actually or by reason of this subsection), its acquiring corporation shall be considered to have been in existence on such date.

"(g) COMPONENT CORPORATIONS OF COMPONENT CORPORATIONS.—If a corporation is a component corporation of an acquiring corporation, under subsection (b) or under this subsection, it shall (except for the purposes of section 742(d) (1) and (2) and section 743(a)) also be a component corporation of the corporation of which such acquiring corporation is a component corporation."

SEC. 30.740-1. *Purpose and scope of Supplement A.*—(*a*) The term "Supplement A," when used in these regulations, means sections 740 to 744. Supplement A provides rules governing the right to elect the excess profits credit based on income and the method of computing such credit, in the case of certain "acquiring" corporations. An acquiring corporation is a domestic corporation which has absorbed one or more other domestic corporations in a transaction meeting the requirements set forth in section 740(a). Each such absorbed corporation is designated a component corporation of the acquiring corporation. Furthermore, except for the purposes of section 742(d) (1) and (2) and section 743(a), if an acquiring corporation is later absorbed by another acquiring corporation, all of the component corporations of the first acquiring corporation become component corporations of the second acquiring corporation. A component corporation is designated a qualified component corporation if it or one of its component corporations was actually in existence at the beginning of the acquiring corporation's base period, *i. e.*, on the date in 1936 corresponding to the date on which begins the taxable year for which the excess profits tax is being computed. A foreign corporation can be neither an acquiring corporation nor a component corporation (see section 744).

(*b*) The purpose of Supplement A is in general to attribute to an acquiring corporation the existence of corporations absorbed by it, together with the base period excess profits net income or net loss and the net capital changes of such absorbed corporations, in order (1) that a corporation the corporate life of which in substance, though not in form, includes the base period may elect the excess profits credit based on income and (2) that a corporation composed in whole or in part of qualified component corporations may compute its excess profits credit in the light of the base period experience of the entire enterprise. Accordingly, an acquiring corporation which was not actually in existence prior to January 1, 1940, is, notwithstanding section 712(a), nevertheless given the right to elect the excess profits credit based on income, provided that it has a qualified component corporation. Furthermore, every acquiring corporation which is entitled to and does elect the excess profits credit based on income is required to take the base period experience of all qualified component corporations into account in computing its average base period net income. Finally, an acquiring corporation is required to add to its daily capital addition or reduction the net capital addition or reduction of each component corporation.*

SEC. 30.740-2. *Transactions whereby a corporation becomes an acquiring corporation.*—(*a*) The types of transactions whereby a corporation can become an acquiring corporation are specifically described in section 740(a). In addition to statutory mergers and consolidations and the acquisition of property in a complete liquidation in which gain or loss is not recognized because of the

provisions of section 112(b)(6) or the same section as contained in the Revenue Act of 1936 or 1938, only the following types of transactions are included:

(1) The acquisition by one corporation, in exchange in whole or in part for all of its stock of all classes (except qualifying shares), of substantially all the properties of another corporation. See section 112(g)(1)(D).

(2) The acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded. See section 112(g)(1)(C). In this type of transaction it is also required that the transferor corporation be forthwith completely liquidated pursuant to the plan under which the transfer of its properties was made and that the transaction of which the transfer is a part have the effect of a statutory merger or consolidation.

(3) The acquisition before October 1, 1940, by one corporation of properties of another corporation solely as paid-in surplus or a contribution to capital in respect of voting stock of the acquiring corporation owned by the transferor corporation, but in determining whether the acquisition is solely as paid-in surplus or a contribution to capital the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded. As in the case of (2) above, it is also required that the transferor corporation be forthwith completely liquidated pursuant to the plan under which the transfer of properties was made and that the transaction of which the transfer is a part have the effect of a statutory merger or consolidation.

(b) The types of transactions set forth in section 740(a), other than those set forth in section 740(a)(1)(C), either are embraced within the definition of a reorganization contained in section 112(g)(1) or are complete liquidations within the meaning of section 112(b)(6). Since Supplement A applies only to cases where there is a sufficient continuity of interest to justify treating a corporation which has acquired the assets of another as standing in the place of such other corporation, such transactions must satisfy all the requirements of the regulations prescribed under section 112 with respect to such transactions, in order that the transferee corporation may be treated as an acquiring corporation.*

SEC. 30.740-3. *Base period and base period years of acquiring corporation.*—The base period of an acquiring corporation is the period of 48 months beginning on the date in 1936 corresponding to the date on which begins the acquiring corporation's taxable year for which the excess profits tax is being computed. For example, if the taxable year for which the excess profits tax of an acquiring corporation is being computed begins on January 1, the base period of such corporation is the period January 1, 1936, to December 31, 1939, both dates inclusive. Such rule applies even though the corporation may have had a different base period in connection with the computation of the excess profits tax for some previous taxable year and even though the acquiring corporation is not organized until after 1940.

The base period years of an acquiring corporation are four in number, being composed of the four successive 12-month periods beginning on the same date as the beginning of its base period. Thus, if the base period begins January 1, 1936, the four base period years are the four calendar years 1936, 1937, 1938, and 1939.*

"SEC. 741. ELECTION OF INCOME CREDIT.

"In addition to the corporations which under section 712(a) may elect the excess profits credit computed under section 713 or the excess profits credit computed under section 714, a taxpayer which is an acquiring corporation which was in existence on the date of the beginning of its base period shall have such election."

SEC. 30.741-1. *Election of income credit.*—Like any other domestic corporation, an acquiring corporation is entitled under section 712(a) to elect the excess profits credit based on income if it was itself actually in existence prior to January 1, 1940. Whether or not it was so in existence, however, it is entitled under section 741 to elect the excess profits credit based on income if it was constructively in existence at the beginning of its 48-month base period by virtue of having acquired a qualified component corporation.

Every such election must be made within the time and in the manner provided in section 712(a) and the regulations prescribed thereunder."

"SEC. 742. AVERAGE BASE PERIOD NET INCOME.

"In the case of a taxpayer which is an acquiring corporation which was actually in existence on the date of the beginning of its base period, or which is entitled under section 741 to elect the excess profits credit computed under section 713, its average base period net income (for the purpose of the credit computed under section 713) shall be computed as follows, in lieu of the method provided in section 713:

"(a) By ascertaining with respect to each of its base period years—

"(1) The amount of its excess profits net income for each of its taxable years beginning after December 31, 1935, and ending with or within such base period year; or, in the case of each such taxable year in which the deductions plus the credit for dividends received exceeded the gross income, the amount of such excess;

"(2) With respect to each of its qualified component corporations, the amount of its excess profits net income for each of its taxable years beginning after December 31, 1935, and ending with or within such base period year of the taxpayer; or, in the case of each such taxable year in which the deductions plus the credit for dividends received exceeded the gross income, the amount of such excess;

"(3) (A) The aggregate of the amounts of excess profits net income ascertained under paragraphs (1) and (2); (B) the aggregate of the excesses ascertained under paragraphs (1) and (2); and (C) the difference between the aggregates found under clause (A) and clause (B). If the aggregate ascertained under clause (A) is greater than the aggregate found under clause (B), the difference shall for the purposes of subsection (b) be designated a 'plus amount', and if the aggregate ascertained under clause (B) is greater than the aggregate found under clause (A), the difference shall for the purposes of subsection (b) be designated a 'minus amount'.

"(b) By adding the plus amounts ascertained under subsection (a) (3) for each year of the base period; and by subtracting from such sum, if for two or more years of the base period there was a minus amount, the sum of such minus amounts, excluding the greatest.

"(c) By dividing the amount ascertained under subsection (b) by four.

"(d) In no case shall the average base period net income be less than zero. In the case of a taxpayer which becomes an acquiring corporation in any taxable year beginning after December 31, 1939, if, on September 11, 1940, and at all times until the taxpayer became an acquiring corporation—

"(1) the taxpayer owned not less than 75 per centum of each class of stock of each of the qualified component corporations involved in the transaction in which the taxpayer became an acquiring corporation; or.

"(2) one of the qualified component corporations involved in the transaction owned not less than 75 per centum of each class of stock of the taxpayer, and of each of the other qualified component corporations involved in the transaction,

the average base period net income of the taxpayer shall not be less than (A) the average base period net income of that one of its qualified component corporations involved in the transaction the average base period net income of which is greatest, or (B) the average base period net income of the taxpayer computed without regard to the base period net income of any of its qualified component corporations involved in the transaction.

"(e) For the purposes of subsection (a) (1) and (2) of this section—

"(1) There shall be excluded, in the various computations, any dividends paid by the taxpayer or any of its qualified component corporations during any of the taxable years of the payor which are included in the computation of the taxpayer's average base

period net income. If the payor corporation is a corporation described in subsection (f)(1) or (2) of this section, the dividends to be excluded under this paragraph shall be only such as are paid after such payor corporation first became an acquiring corporation; and

"(2) In determining whether, for any taxable year, the deductions plus the credit for dividends received exceeded the gross income, and in determining the amount of such excess, the adjustments provided in section 711(b)(1) shall be made.

"(f)(1) In the case of a taxpayer which is an acquiring corporation and which was not actually in existence on the date of the beginning of its base period, there shall be excluded from the various computations under subsections (a)(1) of this section the portion of its excess profits net income, or of the excess over gross income therein referred to, which is attributable to any period before it first became an acquiring corporation.

"(2) In the case of a component corporation which became a qualified component corporation only by reason of section 740(f), there shall be excluded from the various computations under subsection (a)(2) of this section the portion of its excess profits net income, or of the excess over gross income therein referred to, which is attributable to any period before it first became an acquiring corporation.

"(3) In the case of a qualified component corporation which was actually in existence on the date of the beginning of the taxpayer's base period, there shall be excluded from the various computations under subsection (a)(2) of this section the portion of its excess profits net income, or of the excess over gross income therein referred to, which is attributable to the period before such date.

"(4) If during the taxable year for which tax is computed under this subchapter the taxpayer acquires assets in a transaction which constitutes it an acquiring corporation, the amount includible under subsection (a)(2), attributable to such transaction, shall be limited to an amount which bears the same ratio to the amount computed without regard to this paragraph as the number of days in the taxable year after such transaction bears to the total number of days in such taxable year."

SEC. 30.742-1. *Average base period net income.*—(*a*) *General.*—Every acquiring corporation electing the excess profits credit based on income which was itself actually in existence at the beginning of its base period or which has a qualified component corporation is required to compute its average base period net income in accordance with section 742, in lieu of the method provided by section 713(b). Three steps are necessary in making such computation, as follows:

(1) The excess profits net income or excess of deductions plus the credit for dividends received over gross income (hereinafter referred to as "net loss") of the acquiring corporation and each qualified component corporation for each taxable year beginning after December 31, 1935, and ending with or within a base period year of the acquiring corporation must be determined.

(2) The group excess profits net income or group net loss for each base period year of the acquiring corporation, *i. e.*, the aggregate of the amounts determined with respect to each corporation separately for taxable years ending with or within such base period year, must be determined as provided in paragraph (*c*) of this section.

(3) The taxpayer's average base period net income is then ascertained by determining the aggregate of the group excess profits net incomes and net losses (except the greatest, which is treated as zero) and dividing by 4, as provided in paragraph (*d*) of this section.

(*b*) *Determination of excess profits net income or net loss of acquiring corporation and each qualified component corporation.*—The first step in computing the average base period net income of an acquiring corporation is the determination of the excess profits net income or net loss of the acquiring corporation and each qualified component corporation for each taxable year beginning after December 31, 1935, and ending with or within a base period year of the acquiring corporation. Such excess profits net income or net loss shall be computed with the adjustments provided in section 711(b).

(*c*) *Determination of group excess profits net income or net loss.*—(1) *General.*—The group excess profits net income or net loss of an acquiring corporation

for each base period year is determined by adding together the excess profits net incomes of the several corporations determined under paragraph (*b*) of this section for each taxable year ending with or within such base period year and subtracting from such sum the sum of the net losses so determined for each such taxable year, with the exceptions and limitations set forth in (2) below. If the sum of the excess profits net incomes for such base period year exceeds the sum of the net losses for such base period year, the difference is the group excess profits net income for such base period year. If the sum of the net losses exceeds the sum of the excess profits net incomes, the difference is the group net loss for such base period year. This paragraph may be illustrated by the following examples:

Example (*1*): The X Corporation, which was organized prior to 1936, is computing its excess profits tax for the calendar year 1940. In 1939 it became an acquiring corporation of the Y Corporation and the Z Corporation, both of which were in existence on January 1, 1936. During the X Corporation's base period the Y Corporation made its income tax returns on the basis of the fiscal year beginning July 1. During the same period the Z Corporation made its income tax returns on the calendar year basis. For the calendar year 1936 the X Corporation had an excess profits net income of $50,000, and the Z Corporation had an excess profits net income of $20,000. For its first base period year, *i. e.*, the calendar year 1936, the group excess profits net income of X, the acquiring corporation, is $70,000, computed as follows:

Excess profits net income of the X Corporation for 1936	$50,000
Plus: Excess profits net income of the Z Corporation for 1936	20,000
Group excess profits net income for 1936	70,000

The Y Corporation's fiscal year ending June 30, 1936, can not be taken into account since it is a taxable year beginning prior to January 1, 1936.

Example (*2*): If for the calendar year 1937 the X Corporation had an excess profits net income of $75,000 and the Z Corporation had an excess profits net income of $30,000 and if the Y Corporation for the fiscal year ending June 30, 1937, had a net loss of $5,000, the X Corporation would have a group excess profits net income for its second base period year, *i. e.*, the calendar year 1937, of $100,000, computed as follows:

Excess profits net income of the X Corporation for 1937	$75,000
Plus: Excess profits net income of the Z Corporation for 1937	30,000
Total	105,000
Less: Net loss of the Y Corporation fiscal year ending June 30, 1937	5,000
Group excess profits net income for 1937	100,000

Example (*3*): If for the calendar year 1938 the X Corporation had an excess profits net income of $40,000 and the Z Corporation had a net loss of $50,000 and if the Y Corporation for the fiscal year ending June 30, 1938, had an excess profits net income of $5,000, the X Corporation would have a group net loss for its third base period year, *i. e.*, the calendar year 1938, of $5,000, computed as follows:

Net loss of the Z Corporation for 1938		$50,000
Less:		
Excess profits net income of the X Corporation for 1938	$40,000	
Excess profits net income of the Y Corporation for fiscal year ending June 30, 1938	5,000	
		45,000
Group net loss for 1938		5,000

(2) *Exceptions and limitations.*—The amount of excess profits net income or net loss of an acquiring corporation or a qualified component corporation for a taxable year beginning after December 31, 1935, and ending with or within a base period year which may be included in computing the group excess profits net income or net loss for such base period year is to be determined in accordance with the following exceptions and limitations:

(i) An acquiring corporation which was not itself actually in existence at the beginning of its base period is not permitted to take into account any of

its own excess profits net income or net loss attributable to any period before it first became an acquiring corporation (see section 742(f)(1)). The same rule is applicable to the excess profits net income or net loss of a qualified component corporation which was not actually in existence at the beginning of the taxpayer's base period (see section 742(f)(2)). This rule may be illustrated by the following example:

Example: The A Corporation was organized prior to 1936. The B Corporation was organized January 1, 1938. On July 1, 1939, the B Corporation acquired the A Corporation in a transaction described in section 740(a). In computing its average base period net income, the B Corporation may not take into account any portion of its own excess profits net income or net loss attributable to the period preceding July 1, 1939. It is required, however, to take into account the excess profits net income or net loss of the A Corporation for such period. If the B Corporation is subsequently acquired by the C Corporation, the C Corporation will likewise not be permitted to take into account the excess profits net income or net loss of the B Corporation attributable to the period preceding July 1, 1939, in computing its own average base period net income, but will be required to take into account with respect to such period the excess profits net income or net loss of the A Corporation. Such rule is applicable whether or not the C Corporation was actually in existence at the beginning of its base period.

The excess profits net income or net loss of such an acquiring or qualified component corporation for the entire period following the date when it first becomes an acquiring corporation is to be taken into account, however, even though when it first becomes an acquiring corporation it does not acquire a qualified component corporation but merely a component corporation.

(ii) If the first taxable year of a qualified component corporation which ends with or within the taxpayer's first base period year began prior to the beginning of such base period year (though after December 31, 1935), so much of such qualified component corporation's excess profits net income or net loss for such taxable year must be excluded as is attributable to the period before the beginning of such first base period year (see section 742(f)(3)). For example, if the acquiring corporation's base period begins on July 1, 1936, but the taxable year of one of its qualified component corporations is the calendar year 1936, only so much of such qualified component corporation's excess profits net income or net loss for the calendar year 1936 may be included in computing the group excess profits net income or net loss for the 12-month period beginning July 1, 1936, as is attributable to the period beginning July 1, 1936, and ending December 31, 1936.

(iii) In case a corporation becomes an acquiring corporation in an excess profits tax taxable year, only a proportionate amount of the excess profits net income or net loss of any qualified component corporation acquired upon such transaction may be included in computing the taxpayer's average base period net income for purposes of the excess profits credit for such taxable year. The amount thereof which may be included with respect to each base period year is an amount which bears the same ratio to the total amount of the excess profits net income or net loss of such qualified component corporation otherwise includible in such base period year as the number of the days in the taxable year after the acquisition takes place bears to the total number of days in the taxable year. (See section 742(f)(4).) In the computation of the excess profits credit based on income for subsequent taxable years, the average base period net income shall reflect the full amount of the base period excess profits net income or net loss of such qualified component corporation. This paragraph may be illustrated by the following example:

Example: On July 1, 1940, the X Corporation acquires the Y Corporation in a transaction described in section 740(a). Both the X Corporation and the Y Corporation were in existence on January 1, 1936, and both corporations have always filed their income tax returns on the calendar year basis. The Y Corporation had an excess profits net income of $100,000 for the calendar year 1936, a net loss of $10,000 for the calendar year 1937, an excess profits net income of $70,000 for the calendar year 1938, and an excess profits net income of $50,000 for the calendar year 1939. In computing its average base period net income for purposes of the excess profits credit for the calendar year 1940, the X Corporation may include only one-half of the above amounts, *i. e.*, $50,000 for 1936, minus $5,000 for 1937, $35,000 for 1938, and $25,000 for 1939. In computing the excess profits credit for 1941 and subsequent years,

however, the X Corporation may include the full amount of the base period excess profits net incomes and net loss of the Y Corporation.

(iv) No adjustment need be made under section 742(e)(1) on account of dividends, since the excess profits net income will not include dividends received from a domestic corporation (see section 711(a)(1)(F)).

(*d*) *Determination of average base period net income.*—The average base period net income of an acquiring corporation is the sum of the group excess profits net incomes for the base period years for which there were group excess profits net incomes, reduced by the sum of the group net losses for the base period years for which there were group net losses (except the year for which the greatest or only group net loss was sustained, which is treated as zero), the remainder being divided by 4. In no case, however, shall the average base period net income be less than zero. This paragraph may be illustrated by the following example:

Example: The group net income or group net loss of the P Corporation for each of its base period years is as follows (a group net loss being preceded by a minus sign):

First base period year	$100,000
Second base period year	−50,000
Third base period year	−25,000
Fourth base period year	75,000

The average base period net income of the P Corporation is $37,500, computed as follows:

Group excess profits net income for first year	$100,000
Plus:	
Group excess profits net income for fourth year	75,000
Total	175,000
Less:	
Group net losses, excluding greatest	25,000
Remainder	150,000
Average base period net income ($150,000 divided by 4)	37,500

Section 742(d) provides for a minimum average base period net income in the case of a taxpayer which becomes an acquiring corporation in a transaction taking place in a taxable year beginning after December 31, 1939, if, on September 11, 1940, and at all times thereafter until the transaction takes place, either the taxpayer owns at least 75 per cent of each class of stock of each qualified component corporation involved in the transaction, or one of such qualified component corporations owns at least 75 per cent of each class of stock of the taxpayer and each of the other qualified component corporations. In such case the average base period net income of the taxpayer shall not be less than its average base period net income computed as though the transaction had not taken place, or the largest average base period net income among such qualified component corporations. For the purposes of this paragraph section 740(g) is not applicable.

"SEC. 743. NET CAPITAL CHANGES.

"(a) For the purposes of section 713(c), upon the date of the transaction which constitutes a corporation an acquiring corporation, there shall be added to its daily capital addition or reduction for such day, the net capital addition or reduction, as the case may be, of each of the component corporations involved in such transaction, but no other capital addition or reduction shall be considered as having been made by reason of such transaction.

"(b) For the purposes of this section—

"(1) In computing the net capital addition of each such component corporation there shall be disregarded property paid in to such corporation by the taxpayer or by any of its component corporations.

"(2) In computing the net capital reduction of each such component corporation there shall be disregarded distributions made to the taxpayer or to any of such component corporations."

SEC. 30.743–1. *Net capital changes.*—No capital addition or reduction shall result to an acquiring corporation from the acquisition of a component corporation, except to the extent such component corporation has a net capital addition or reduction upon the date the transaction takes place. Any such net capital addition or reduction shall be added to the daily capital addition or reduction of the acquiring corporation for the day the transaction takes place and for each day thereafter. The net capital addition or reduction of a component corporation is the difference between the daily capital addition and the daily capital reduction of such component corporation for the day the transaction takes place, but in determining such daily capital addition or reduction money or other property paid in on such day and distributions (other than out of earnings and profits) made on such day or pursuant to the plan under which the acquisition is made shall be taken into account except as provided in section 743(b) and except distributions of stock of the acquiring corporation. For the purposes of this paragraph section 740(g) is not applicable and, accordingly, a corporation is a component corporation of only its immediate acquiring corporation. If its acquiring corporation is subsequently acquired by another corporation, its net capital addition or reduction will be added to the daily capital addition or reduction of such other corporation only to the extent that it is reflected in the net capital addition or reduction of its immediate acquiring corporation.

In determining the net capital addition or reduction of a component corporation, money or other property paid in by and distributions made to the taxpayer or any other component corporations of the taxpayer shall be disregarded. For this purpose the term "component corporation" includes a component corporation of a component corporation of the taxpayer as provided in section 740(g).

This section may be illustrated by the following example:

Example: On March 1, 1940, the X Corporation, in exchange solely for its voting stock, acquires all the assets of the Y Corporation, having an adjusted basis for computing loss in the hands of the Y Corporation of $100,000. Immediately after the exchange the Y Corporation distributes the stock of the X Corporation in complete liquidation. Both corporations make their income tax returns on a calendar year basis. The only money or other property paid in to and distribution made by the Y Corporation from January 1, 1940, to March 1, 1940, were as follows:

January 15, $5,000 paid in for stock by persons other than the X Corporation or any component corporation thereof.

February 1, distribution to shareholders of $10,000, of which only $7,000 was out of earnings and profits.

At no time from January 1, 1940, to March 1, 1940, did the Y Corporation have any excluded capital.

The Y Corporation has a net capital addition on March 1, 1940, of $2,000, computed as follows:

Capital additions (money paid in for stock January 15)	$5,000
Less:	
Capital reductions (distribution February 1, to the extent not chargeable to earnings and profits ($10,000 minus $7,000))	3,000
Net capital addition	2,000

Such net capital addition of $2,000 is added to the daily capital addition of the X Corporation for March 1, 1940, and for each day thereafter, but no portion of the $100,000 paid in for stock on March 1, 1940, may be taken into account.*

"SEC. 744. FOREIGN CORPORATIONS.

"The term 'corporation' as used in this Supplement does not include a foreign corporation.

"Supplement B—Highest Bracket Amount and Invested Capital.

"SEC. 750. DEFINITIONS.

"As used in this Supplement—

"(a) EXCHANGE.—The term 'exchange' means an exchange, to which section 112(b)(4) or (5) or so much of section 112(c),(d), or (e) as

refers to section 112(b)(4) or (5), or to which a corresponding provision of a prior revenue law, is or was applicable, by one corporation of its property wholly or in part for stock or securities of another corporation, or a transfer of property by one corporation to another corporation after December 31, 1917, the basis of which in the hands of such other corporation is or was determined under section 113(a)(8)(B), or would have been so determined had such section been in effect.

"(b) TRANSFEROR UPON AN EXCHANGE.—The term 'transferor upon an exchange' means a corporation which upon an exchange transfers property to another corporation in exchange, wholly or in part, for stock or securities of such other corporation, or transfers property to another corporation after December 31, 1917, the basis of which in the hands of such other corporation is or was determined under section 113(a)(8)(B), or would have been so determined had such section been in effect.

"(c) TRANSFEREE UPON AN EXCHANGE.—The term 'transferee upon an exchange' means a corporation which upon an exchange acquires property from another corporation in exchange, wholly or in part, for its stock or securities, or which acquires property from another corporation after December 31, 1917, the basis of which in its hands is or was determined under section 113(a)(8)(B), or would have been so determined had such section been in effect.

"(d) CONTROL.—The term 'control' means the ownership of stock possessing at least 90 per centum of the total combined voting power of all classes of stock entitled to vote and at least 90 per centum of the total value of shares of all classes of stock of the corporation.

"(e) HIGHEST BRACKET AMOUNT.—The term 'highest bracket amount' means $500,000 or the highest bracket amount computed under section 752, whichever is the smaller."

SEC. 30.750–1. *Purpose and scope of Supplement B.*—The term "Supplement B," when used in these regulations, means sections 750 to 752. The purpose of Supplement B is twofold.

Supplement B provides rules relative to the extent to which equity invested capital and borrowed capital are affected by the acquisition of property in an exchange meeting the requirements of section 750(a) (see section 751). Such rules are applicable in the case of exchanges occurring prior to the beginning of the acquiring corporation's first excess profits tax taxable year as well as exchanges occurring thereafter. The purpose of section 751 is in general to provide a rule for the determination of the extent to which property is paid in for stock in cases involving an assumption of liabilities and the payment of boot, and to prevent a duplication in invested capital in cases where bonds as well as stock are issued as consideration for the transfer of the properties acquired.

Supplement B also provides rules for the determination of the "highest bracket amount" of certain corporations which, after the beginning of the excess profits tax period, have been parties to an exchange meeting the requirements of section 750(a) (see section 752). The highest bracket amount is a figure which is to be substituted for the $500,000 figure contained in the highest tax bracket in section 710(a)(1) and is also used in adjusting the other brackets in the rate schedule contained in such section. The purpose of section 752 is in general to prevent a lowering of the effective rates of tax through dividing up the income of one enterprise among several corporate entities by the organization of subsidiaries. For example, section 752, together with section 710(a)(2), is designed to make certain that, if the A Corporation divides itself into the A Corporation and the B Corporation, the effective rate of tax applicable to the A Corporation and the B. Corporation together will be the same as the effective rate of tax which would be applicable to the A Corporation in undivided form.*

SEC. 30.750–2. *Exchange.*—As used in Supplement B the term "exchange" means an exchange, to which section 112(b)(4) or (5) or so much of section 112(c),(d), or (e) as refers to section 112(b)(4) or (5), or to which a corresponding provision of a prior revenue law, is or was applicable, by one corporation of its property wholly or in part for stock or securities of another corporation, or a transfer of property by one corporation to another corporation

after December 31, 1917, the basis of which in the hands of such other corporation is or was determined under section 113(a)(8)(B), or would have been so determined had such section been in effect. As so defined the term "exchange" includes a statutory merger or consolidation. The fact that the property transferred consists solely of cash will not prevent a transaction from qualifying as an exchange within the meaning of section 750(a). Moreover, a transaction which would not be within section 112(b)(4) of the Internal Revenue Code but was within the corresponding provision of the Revenue Act applicable to the taxable year in which it took place, because of differences in the definition of the term "reorganization" contained in such Revenue Act, is an exchange within the meaning of section 750(a).*

SEC. 30.750-3. *Control.*—In determining whether "control," as that term is defined in section 750(d), exists, Treasury stock is not to be taken into account. Since the term "control" means, in addition to the ownership of stock possessing at least 90 per cent of the total combined voting power of all classes of stock entitled to vote, ownership of at least 90 per cent of the total value of shares of all classes of stock (including voting stock) of the corporation, it will frequently be necessary to value each class of stock separately. For the purposes of section 750(d) the term "value" means fair market value. If stock not owned is all of a single class it will be necessary to make a separate valuation only of such class of stock and to compare such value with the combined value of all the stock, since by so doing it will be possible to determine whether the stock not owned exceeds 10 per cent of the total value of shares of all classes of stock of the corporation. The element of control is of consequence only in connection with the application of section 752, which does not apply to an exchange taking place prior to 1940.*

SEC. 30.750-4. *Highest bracket amount.*—The highest bracket amount of a corporation which has not, after the beginning of the excess profits tax period, been a transferor or transferee upon an exchange as defined in section 750(b) and (c) is $500,000. Whenever a corporation becomes such a transferor or transferee, such $500,000 amount is adjusted as provided in section 752 both for the taxable year the exchange takes place and for subsequent taxable years. The adjusted figure, which can never exceed but may be less than $500,000, is the corporation's highest bracket amount until a subsequent exchange, or a complete liquidation, subject to the provisions of section 112(b)(6), of a subsidiary to which property was transferred on a previous exchange subject to section 752, makes a further adjustment necessary.*

"SEC. 751. DETERMINATION OF PROPERTY PAID IN FOR STOCK AND OF BORROWED CAPITAL IN CONNECTION WITH CERTAIN EXCHANGES.

"(a) PROPERTY PAID IN FOR STOCK.—In the application of section 718(a) to a transferee upon an exchange in determining the amount paid in for stock of the transferee, or as paid-in surplus or as a contribution to capital of the transferee, in connection with such exchange, only an amount shall be deemed to have been so paid in equal to the excess of the basis in the hands of the transferee of the property of the transferor received by the transferee upon the exchange over the sum of—

"(1) Any liability of the transferor assumed upon such exchange and any liability subject to which the property was received upon such exchange, plus

"(2) The aggregate of the amount of money and the fair market value of any other property transferred to the transferor not permitted to be received by such transferor without the recognition of gain.

"(b) BORROWED CAPITAL.—In the application of section 719(a) to a transferee upon an exchange, the term 'borrowed capital' shall not include indebtedness originally evidenced by securities issued by the transferee upon such exchange as consideration for the property of the transferor received by the transferee upon such exchange if (1) such securities were properly permitted to be received by the person to whom such securities were issued without the recognition of gain and (2) the indebtedness originally evidenced by such securities did not arise out of indebtedness of the transferor (other than indebtedness which in the transferor's hands was subject to the limitations

of this subsection) assumed by the transferee in connection with such exchange."

SEC. 30.751-1. *Property paid in for stock.*—The amount to be treated as property paid in for stock, or as paid-in surplus, or as a contribution to capital of a transferee in connection with an exchange is the unadjusted basis for determining loss in the hands of the transferee of the property transferred (adjusted in the case of a substituted basis, as provided in section 113(b)(2)) reduced by the sum of the following:

(*a*) Any liability of the transferor assumed upon such exchange and any liability subject to which the property was transferred, plus

(*b*) The aggregate of the amount of money and the fair market value of any other property received by the transferor from the transferee upon such exchange, not permitted to be received by such transferor without the recognition of gain.

This section may be illustrated by the following example:

Example: The X Corporation in 1940 transfers all its property to the Y Corporation in exchange for stock having a fair market value of $200,000 and constituting 80 per cent of each class of stock of the Y Corporation, $10,000 in bonds of the Y Corporation, $5,000 in cash, and the assumption by the Y Corporation of the liabilities of the X Corporation amounting to $45,000. None of the consideration received was distributed by the X Corporation to its shareholders. The adjusted basis for gain or loss in the hands of the X Corporation of the assets transferred is $100,000 at the time of the transfer. The amount to be treated as property paid in for stock of the Y Corporation is $55,000, computed as follows:

(1) Adjusted basis of property in hands of the X Corporation		$100,000
(2) Plus: Gain recognized under section 112(d)(2)		5,000
(3) Basis under section 113(a)(7) (adjusted as provided in section 113(b)(2)) in hands of the Y Corporation		105,000
(4) Less the sum of:		
Liabilities of the X Corporation assumed by the Y Corporation	$45,000	
Money received by the X Corporation	5,000	
		50,000
(5) Property paid in for stock of the Y Corporation ((3) minus (4))		55,000

SEC. 30.751-2. *Limitation on borrowed capital.*—A transferee may not treat as borrowed capital any indebtedness originally evidenced by its securities issued upon an exchange and permitted to be received by the persons to whom issued without the recognition of gain, except and to the extent that such securities were issued in assumption of indebtedness of the transferor not excluded from the borrowed capital of the transferor by virtue of this section.

This section may be illustrated by the following example:

Example: The X Corporation, which has never previously been a party to an exchange, transfers to the Y Corporation all its property in exchange for all the stock of the Y Corporation and $50,000 of bonds of the Y Corporation, $20,000 of which are issued to the bondholders of the X Corporation in assumption of the liabilities of the X Corporation. As a result of such transaction the Y Corporation is entitled to a borrowed capital of only $20,000 (producing a borrowed invested capital of $10,000), since the remaining $30,000 of bonds are property permitted to be received without the recognition of gain and are not issued in connection with the assumption of liabilities of the X Corporation.*

"SEC. 752. COMPUTATION OF HIGHEST BRACKET AMOUNT IN CONNECTION WITH EXCHANGES.

"(a) SPECIAL APPLICATION OF DAILY INVESTED CAPITAL OF TRANSFEROR UPON EXCHANGE.—For the purposes of this section, the daily invested capital of a transferor upon an exchange for the day after the exchange shall be the daily invested capital determined under section 717 reduced by an amount equal to the amount by which the equity

Invested capital of the transferee upon such exchange was increased by reason of the receipt of property from such transferor upon such exchange.

"(b) HIGHEST BRACKET AMOUNT OF TRANSFEROR.—

"(1) TAXABLE YEAR OF EXCHANGE.—In the case of a transferor upon an exchange after the beginning of its first taxable year under this subchapter, its highest bracket amount for the taxable year in which the exchange takes place shall be the sum of—

"(A) Its highest bracket amount immediately preceding the exchange multiplied by the number of days in the taxable year up to and including the day of the exchange, plus

"(B) Its highest bracket amount for the taxable year after the exchange, multiplied by the number of days in the taxable year remaining after the day of the exchange,

divided by the number of days in the taxable year.

"(2) TAXABLE YEARS AFTER EXCHANGE INVOLVING CONTROL.—In the case of a transferor upon an exchange after the beginning of its first taxable year under this subchapter, if immediately after the exchange the transferor or its shareholders, or both, are in control of the transferee, the transferor's highest bracket amount for any taxable year after the taxable year in which the exchange takes place shall be an amount which is a percentage of its highest bracket amount immediately preceding the exchange equal to the percentage which is its daily invested capital for the day after the exchange is of its daily invested capital for the day of the exchange.

"(3) TAXABLE YEARS AFTER EXCHANGE NOT INVOLVING CONTROL.—In the case of a transferor upon an exchange (other than a transferor described in paragraph (4) of this subsection) after the beginning of its first taxable year under this subchapter, if immediately after the exchange no transferor or its shareholders, or both, upon the exchange are in control of the transferee, and if the shareholders of the transferee immediately preceding the exchange are not in control of the transferee immediately after the exchange, the transferor's highest bracket amount for any taxable year after the exchange shall be the excess, if any, of the sum of the transferor's highest bracket amount immediately preceding the exchange and the transferee's highest bracket amount immediately preceding the exchange, over $500,000.

"(4) TAXABLE YEARS AFTER CERTAIN EXCHANGES UNDER SECTION 112(b)(5).—In the case of an exchange after the beginning of the first taxable year under this subchapter of any transferor or transferee upon such exchange, involving two or more transferors, or one or more transferors and one or more other persons, if immediately after the exchange no one of such transferors, or its shareholders, or both, and no one or more of such other persons are in control of the transferee and if such exchange is an exchange described in section 112(b)(5) or so much of section 112(c) or 112(e) as refers to section 112(b)(5), the highest bracket amount of any such transferor for any taxable year after the exchange shall be an amount equal to its highest bracket amount immediately preceding the exchange—

"(A) Minus an amount which bears the same ratio to its highest bracket amount immediately preceding the exchange as the excess of its daily invested capital for the day of the exchange over its daily invested capital for the day after the exchange bears to its daily invested capital for the day of the exchange, and

"(B) Plus an amount which bears the same ratio to the excess over $500,000 of the sum of the amounts computed under subparagraph (A) with respect to each transferor, as the amount computed under subparagraph (A) with respect to such transferor bears to the sum of the amounts computed under such subparagraph with respect to each transferor.

"(c) HIGHEST BRACKET AMOUNT OF TRANSFEREE.—

"(1) TAXABLE YEAR OF EXCHANGE INVOLVING CONTROL.—In the case of a transferee upon an exchange after the beginning of the first taxable year under this subchapter of a transferor upon such exchange the transferee's highest bracket amount for the taxable year in which the exchange takes place shall be the sum of—

"(A) Its highest bracket amount immediately preceding the exchange multiplied by the number of days in the taxable year up to and including the day of the exchange, plus

"(B) Its highest bracket amount for the taxable year after the exchange multiplied by the number of days in the taxable year remaining after the day of the exchange,

divided by the number of days in the taxable year. For the purposes of this paragraph and subsection (d) of this section 'exchange' includes a liquidation described in paragraph (5) of this subsection, and such exchange shall be deemed to have taken place on the day such liquidation was completed.

"(2) TAXABLE YEARS AFTER EXCHANGE INVOLVING CONTROL.—In the case of a transferee upon an exchange after the beginning of the first taxable year under this subchapter of a transferor upon such exchange, if immediately after the exchange any transferor upon such exchange or its shareholders, or both are in control of the transferee, the transferee's highest bracket amount for any taxable year after the exchange shall be an amount which is a percentage of such transferor's highest bracket amount immediately preceding the exchange equal to the percentage which the excess of the transferee's daily invested capital for the day after the exchange over its daily invested capital for the day of the exchange is of such transferor's daily invested capital for the day of the exchange.

"(3) TAXABLE YEARS AFTER EXCHANGE NOT INVOLVING CONTROL.—In the case of a transferee upon an exchange (other than a transferee described in paragraph (4) of this subsection) after the beginning of the first taxable year under this subchapter of a transferor upon such exchange, if immediately after the exchange no transferor or its shareholders, or both, are in control of the transferee, and if the shareholders of the transferee immediately preceding the exchange are not in control of the transferee immediately after the exchange, the transferee's highest bracket amount for any taxable year after the exchange shall be an amount equal to (A) the sum of the transferor's highest bracket amount immediately preceding the exchange and the transferee's highest bracket amount immediately preceding the exchange, or (B) $500,000, whichever is the smaller.

"(4) TAXABLE YEARS AFTER CERTAIN EXCHANGES UNDER SECTION 112(b)(5).—In the case of an exchange described in subsection (b)(4) of this section, the highest bracket amount of the transferee upon such exchange for any taxable year after the exchange shall be an amount equal (A) to the sum of the amounts computed under subparagraph (A) of such subsection with respect to each transferor or (B) $500,000, whichever is the smaller.

"(5) TAXABLE YEARS AFTER LIQUIDATION IN CASE OF CORPORATION RECEIVING PROPERTY UNDER SECTION 112(b)(6).—Upon the receipt by a corporation during any taxable year under this subchapter of property in complete liquidation of another corporation, gain or loss upon which is not recognized by reason of section 112(b)(6), the highest bracket amount of the corporation receiving such property for any taxable year after the liquidation is completed shall be an amount equal to its highest bracket amount immediately preceding the completion of the liquidation increased, but in no case to an amount above $500,000, by an amount equal to the highest bracket amount of such other corporation immediately preceding the completion of such liquidation, if previously and after the beginning of the first taxable year under this subchapter of the corporation receiving such property such corporation was a transferor upon an exchange with respect to which such other corporation was a transferee.

"(d) HIGHEST BRACKET AMOUNT IN CASE OF TWO OR MORE EXCHANGES IN SAME TAXABLE YEAR.—

"(1) If a transferor upon an exchange is in the same taxable year involved in more than one exchange (either as transferor or transferee), its highest bracket amount for such taxable year shall be the amount determined under subsection (b)(1) with respect to the last exchange in such taxable year. Its highest bracket amount immediately preceding any exchange in such taxable year subsequent to the first exchange therein shall be the amount computed under subsection (b)(1) with respect to the immediately preceding exchange as if the taxable year closed on the day of such subsequent exchange.

"(2) If a transferee upon an exchange is in the same taxable year involved in more than one exchange (either as transferee or transferor), its highest bracket amount for such taxable year shall be the amount determined under subsection (c)(1) with respect to the last exchange in such taxable year. Its highest bracket amount immediately preceding any exchange in such taxable year subsequent to the first exchange therein shall be the amount computed under subsection (c)(1) with respect to the immediately preceding exchange as if the taxable year closed on the day of such subsequent exchange.

"(3) If a transferor or transferee upon an exchange is in the same taxable year involved in more than one exchange (either as transferor or transferee), its highest bracket amount for any taxable year after the taxable year in which such exchanges took place shall be the amount computed under subsection (b)(2),(3), or (4), or (c)(2), (3), (4), or (5), as the case may be, with respect to the last such exchange."

SEC. 30.752–1. *Nature and function of highest bracket amount.*—The general rate schedule contained in section 710(a) (1) is composed of six brackets, the dividing lines between which are expressed in terms of fixed amounts of adjusted excess profits net income. Such brackets and the rates of tax applicable thereto are as follows:

	Per cent.
First $20,000	25
Next $30,000	30
Next $50,000	35
Next $150,000	40
Next $250,000	45
Over $500,000	50

The dividing line between the last two brackets is $500,000. This amount is designated as a corporation's "highest bracket amount."

Since the various brackets are defined in terms of absolute amounts of income, an enterprise with $1,000,000 of income, for example, would have a substantially lower tax if the income could be split between two separate corporate entities, for in such case no portion of the income would be subject to the 50 per cent rate. The possibility of obtaining such an advantage through the transfer of properties in an exchange after December 31, 1939, is avoided by adjusting the brackets of both corporations involved in such a transaction so as to make the total amount of income subject to tax in each bracket the same as would have been the case if the enterprise had remained in the form of a single corporate entity. This is accomplished in general by reducing the highest bracket amount of the original corporation in the same proportion as the invested capital of such corporation is reduced as a result of the exchange. Thus, if the invested capital of the corporation is cut in half, the highest bracket amount is also cut in half, and becomes $250,000. The same proportionate reduction is then made in each of the other brackets. The transferee corporation, in the case of such a corporate split-up, is given a highest bracket amount equal to the amount by which the highest bracket amount of the transferor corporation is reduced, and each of the other brackets is likewise proportionately reduced. In the case of a corporation dividing itself in half by the organization of a wholly owned subsidiary, each corporation would be

subject to the following rate schedule for the taxable year following the year in which the transaction took place:

	Per cent.
First $10,000	25
Next $15,000	30
Next $25,000	35
Next $75,000	40
Next $125,000	45
Over $250,000	50

Section 752 is directed only to the determination of the highest bracket amount of each corporation involved in an exchange described in section 750(a) or in certain types of complete liquidations subject to the provisions of section 112(b)(6). The application of such amount in reduction of the rate schedule applicable to such corporation is to be found in section 710(a)(2).

A separate computation under section 752 must be made for the year in which the exchange takes place and for years following such year. Since, in determining the highest bracket amount for the year of the exchange, the highest bracket amount for the year following the exchange must first be determined, these regulations will first set forth the rules governing such latter determination.*

SEC. 30.752–2. *Daily invested capital of transferor upon exchange for purpose of computing highest bracket amount—Application of section 752(a).*—In making the various computations required by section 752(b), (c), and (d) the daily invested capital of a transferor upon an exchange for the day after the exchange is the daily invested capital determined under section 717 reduced by an amount equal to the amount by which the equity invested capital of the transferee upon such exchange is increased by reason of the receipt of property from the transferor. Such rule is applicable only for purposes of section 752. The invested capital of a transferor upon an exchange for purposes of computing the excess profits credit based on invested capital is to be determined under the general rule contained in section 717. For purposes of section 752, as in the case of the general rule, indebtedness constituting borrowed capital of the transferor which is assumed by the transferee is not to be treated as borrowed capital of the transferor for any day following the day the exchange takes place.

This section may be illustrated by the following example:

Example: On December 1, 1940, the X Corporation, which has a daily invested capital for such day of $100,000 consisting entirely of equity invested capital, transfers property with an adjusted basis (for determining loss) of $30,000 to the Y Corporation in exchange for all the stock of the Y Corporation. The daily invested capital of the Y Corporation for December 2, 1940, is therefore $30,000. Under section 717 the daily invested capital of the X Corporation for December 2, 1940, is not affected (though the invested capital for the year will be adjusted on account of inadmissibles). For the purpose of computing the highest bracket amount of the X Corporation and the Y Corporation, however, the daily invested capital of the X Corporation for December 2, 1940, will be $100,000 minus $30,000, or $70,000.*

SEC. 30.752–3. *Highest bracket amount of transferor and transferee for year following exchange where transferor in control—Application of section 752 (b)(2) and (c)(2).*—*(a) Transferor.*—In the case of an exchange as defined in section 750(a) after the beginning of the first excess profits tax taxable year of the transferor upon such exchange, if immediately after the exchange the transferor, or its shareholders, or both, are in control of the transferee, the transferor's highest bracket amount for any taxable year after that in which the exchange takes place shall be the same proportion of its highest bracket amount immediately preceding the exchange as its daily invested capital for the day after the exchange is of its daily invested capital for the day of the exchange. Thus, if its daily invested capital is reduced by 25 per cent as a result of the exchange, the highest bracket amount will be reduced by 25 per cent, *i. e.*, it will be reduced to 75 per cent of what it was before the exchange.

This paragraph may be illustrated by the following example:

Example: On December 1, 1940, the X Corporation, which makes its income tax returns on the calendar year basis and which has a daily invested capital

for December 1 of $100,000, transfers to the Y Corporation property with an adjusted basis (for determining loss) of $30,000 in exchange for all the stock of the Y Corporation. The X Corporation has not previously in 1940 been a party to an exchange and therefore has a highest bracket amount immediately preceding this exchange of $500,000. The daily invested capital of the Y Corporation for December 2, 1940, is $30,000 and the daily invested capital of the X Corporation for purposes of section 752 for December 2, 1940, is therefore $70,000. The highest bracket amount of the X Corporation for the taxable year 1941 is $350,000, *i. e.*, $\frac{70,000}{100,000}$ of $500,000.

(*b*) *Transferee.*—The highest bracket amount of the transferee in an exchange described in paragraph (*a*) of this section for the taxable year following that in which the exchange takes place is the amount by which the transferor's highest bracket amount is reduced on account of such exchange. Thus, the highest bracket amount of the Y Corporation in the example given in paragraph (*a*) of this section for the year following the year in which the exchange takes place is $150,000, *i. e.*, $500,000 minus $350,000.*

SEC. 30.752-4. *Highest bracket amount of transferor and transferee for year following exchange where transferor not in control—Application of section 752 (b) (3) and (c) (3).*—(*a*) *Transferor.*—In the case of an exchange (except an exchange described in section 752(b)(4)) after the beginning of the first excess profits tax taxable year of the transferor, if immediately after the exchange no transferor or its shareholders, or both, are in control of the transferee and the shareholders of the transferee immediately before the exchange are not in control of the transferee immediately after the exchange, the transferor's highest bracket amount for any taxable year after that in which the exchange takes place is the excess, if any, over $500,000 of the sum of the transferor's highest bracket amount immediately preceding the exchange and the transferee's highest bracket amount immediately preceding the exchange. Thus, so much of the highest bracket amount of the transferor immediately preceding the exchange as is not needed to raise the highest bracket amount of the transferee to $500,000 is permitted to be retained by the transferor.

This paragraph may be illustrated by the following example:

Example: On December 1, 1940, the X Corporation, which makes its income tax returns on the calendar year basis, transfers all its assets to the Y Corporation in exchange solely for 75 per cent of the voting stock of the Y Corporation. The X Corporation has not previously in 1940 been a party to an exchange and therefore has a highest bracket amount immediately preceding this exchange of $500,000. The Y Corporation has, however, a highest bracket amount of only $400,000 because of having previously in an excess profits tax taxable year been a party to an exchange. The highest bracket amount of the X Corporation for the year 1941 will be $400,000, computed as follows:

Highest bracket amount of the X Corporation immediately preceding exchange	$500,000
Plus: Highest bracket amount of the Y Corporation immediately preceding exchange	400,000
Total	900,000
Less: $500,000	500,000
Highest bracket amount of the X Corporation for 1941	400,000

(*b*) *Transferee.*—The highest bracket amount of the transferee in an exchange described in paragraph (*a*) of this section for the taxable year following that in which the exchange takes place is (1) the sum of its highest bracket amount immediately preceding the exchange and the highest bracket amount of the transferor immediately preceding the exchange, or (2) $500,000, whichever is smaller. Thus, the highest bracket amount of the Y Corporation in the example given in paragraph (*a*) of this section for the year following the year in which the exchange takes place is $500,000. The highest bracket amount immediately prior to an exchange, of a transferee organized upon such exchange, is $500,000.*

SEC. 30.752-5. *Highest bracket amount of transferor and transferee for year following certain exchanges under section 112(b)(5)—Application of section 752(b)(4) and (c)(4).*—*(a) Transferor.*—If an exchange described in section 112(b)(5) or so much of section 112(c) or (e) as refers to section 112(b)(5) takes place in an excess profits tax taxable year of any party thereto and if, upon such exchange,

there are several corporate transferors, or

in addition to one or more corporate transferors, one or more other persons transfer property to the transferee upon the exchange, and

immediately after the exchange no one of the corporate transferors, or its shareholders, or both, and no one or more of such other persons are in control of the transferee,

the highest bracket amount of each corporate transferor for any taxable year after that in which the exchange takes place is computed as follows:

(1) Its highest bracket amount immediately preceding the exchange is first tentatively reduced in the same proportion as its daily invested capital is reduced as a result of the exchange (see section 30.752-3(*a*)).

(2) There must then be ascertained the excess, if any, over $500,000 of the sum of the amounts by which the highest bracket amounts of all the corporate transferors are tentatively reduced under (1). The highest bracket amount as tentatively reduced under (1) of each corporate transferor is then increased by an amount which bears the same ratio to such excess as the tentative reduction under (1) of such transferor bears to the sum of the tentative reductions under (1) of all the corporate transferors. Thus, the highest bracket amount of each corporate transferor is finally reduced by only so much as is necessary, together with the amounts by which the highest bracket amounts of the other corporate transferors are reduced, to confer upon the transferee a highest bracket amount of $500,000.

This paragraph may be illustrated by the following example:

Example: On December 1, 1940, the X Corporation and the Y Corporation, both of which make their income tax returns on the calendar year basis, have a daily invested capital of $100,000 and $200,000, respectively. Neither corporation has previously in 1940 been a party to an exchange. On such date they organize the Z Corporation to which the X Corporation transfers property having an adjusted basis (for determining loss) of $44,000 for stock of the Z Corporation and the Y Corporation transfers property having an adjusted basis (for determining loss) of $132,000 for the remaining stock of the Z Corporation. All the requirements of section 112(b)(5) are satisfied. The highest bracket amount of the X Corporation for 1941 is $300,000, computed as follows:

(1) Daily invested capital of the X Corporation December 1, 1940	$100,000
(2) Less: Daily invested capital of the X Corporation December 2, 1940	56,000
(3) Difference	44,000
(4) Percentage item (3) is of item (1)	44
(5) Tentative reduction in highest bracket amount of the X Corporation (44 per cent of $500,000)	220,000
(6) Daily invested capital of the Y Corporation December 1, 1940	200,000
(7) Less: Daily invested capital of the Y Corporation December 2, 1940	68,000
(8) Difference	132,000
(9) Percentage item (8) is of item (6)	66
(10) Tentative reduction in highest bracket amount of the Y Corporation (66) per cent of $500,000)	330,000
(11) Sum of items (5) and (10)	550,000
(12) Less: $500,000	500,000
(13) Difference	50,000
(14) Percentage which item (5) is of item (11)	40

(15) 40 per cent of $50,000 (item 13)	$20,000
(16) Highest bracket amount of the X Corporation prior to exchange	500,000
(17) Less: Item (5)	220,000
(18) Difference	280,000
(19) Plus: Item (15)	20,000
(20) Highest bracket amount of the X Corporation for 1941	300,000

The highest bracket amount of the Y Corporation for 1941 is $200,000, computed in the same manner.

(*b*) *Transferee.*—In the case of an exchange described in paragraph (*a*) of this section, the highest bracket amount of the transferee is whichever of the following amounts is the smaller: (1) $500,000, or (2) the sum of the amounts by which the highest bracket amounts of all the corporate transferors are tentatively reduced under section 752(b)(4)(A) and paragraph (*a*)(1) of this section. Thus, in the example given in paragraph (*a*) of this section, the highest bracket amount of the Z Corporation for the taxable year after the exchange takes place is $500,000, that amount being less than $550,000, the sum of the amounts by which the highest bracket amounts of the X Corporation and the Y Corporation are tentatively reduced under paragraph (*a*)(1) of this section ($220,000 plus $330,000).*

SEC. 30.752–6. *Highest bracket amount of transferee for year following certain 112(b)(6) liquidations—Application of section 752(c)(5).*—If a corporation which previously in an excess profits tax taxable year has been a transferor upon an exchange subsequently liquidates under section 112(b)(6) one of the transferees upon such previous exchange, its highest bracket amount for any taxable year after that in which the liquidation is completed is its highest bracket amount immediately preceding the completion of the liquidation, increased, but not to an amount exceeding $500,000, by the highest bracket amount of the corporation which it liquidates. In the case of any other liquidation under section 112(b)(6), the highest bracket amount of the transferee is not affected.

This section may be illustrated by the following example:

Example: On December 1, 1940, the X Corporation is a transferor upon an exchange with respect to which the Y Corporation and the Z Corporation are transferees. As a result of such exchange the highest bracket amounts of the X, Y, and Z Corporations for 1941 are $200,000, $175,000, and $125,000, respectively. The X Corporation subsequently liquidates the Y Corporation under section 112(b)(6). Its highest bracket amount for the year after that in which such liquidation is completed is $375,000, computed as follows:

Highest bracket amount of the X Corporation immediately preceding liquidation	$200,000
Plus: Highest bracket amount of the Y Corporation immediately preceding liquidation	175,000
Highest bracket amount of the X Corporation for next taxable year	375,000

If the highest bracket amount of the X Corporation had, because of some other transaction, been increased from $200,000 to $400,000 between the time of the 1940 exchange and the completion of the liquidation of the Y Corporation, its highest bracket amount for the year after that in which the liquidation is completed would be $500,000, notwithstanding the sum of its highest bracket amount preceding the liquidation and that of the Y Corporation is $575,000 ($400,000 plus $175,000), since no corporation is entitled to a highest bracket amount in excess of $500,000.*

SEC. 30.752–7. *Highest bracket amount for year after exchange or liquidation where more than one transaction in same taxable year—Application of section 752(d)(3).*—The highest bracket amount of a transferor or transferee for any taxable year after that in which several exchanges or liquidations take place is to be determined on the basis of the last such exchange or liquidation. If such determination depends upon the highest bracket amount immediately preceding such last exchange, however, previous transactions will have to be

taken into account, *i. e.*, the highest bracket amount immediately preceding the last transaction is the highest bracket amount for the next taxable year determined on the basis of the last preceding transaction, the highest bracket amount immediately preceding such last preceding transaction is the highest bracket for the next taxable year determined on the basis of the second preceding transaction, which process is continued until the point is reached where the highest bracket amount for the next taxable year can be determined without reference to the highest bracket amount preceding such transaction.

This section may be illustrated by the following example:

Example: On April 1, 1940, the X Corporation, which makes its income tax returns on a calendar year basis, transfers property to the Y Corporation in an exchange as a result of which its highest bracket amount for 1941 becomes $300,000. On June 1, 1940, when its daily invested capital is $250,000, it transfers property with an adjusted basis of $100,000 to the Z Corporation in exchange for all the stock of the Z Corporation. No other exchanges take place during the taxable year 1940. The highest bracket amount of the X Corporation for 1941 is $180,000, computed as follows:

(1) Daily invested capital of the X Corporation for June 1, 1940	$250,000
(2) Less: Increase in daily invested capital of the Z Corporation	100,000
(3) Daily invested capital of X Corporation June 2, 1940	$150,000
(4) Percentage which item (3) is of item (1)	60
(5) Highest bracket amount of the X Corporation for 1941, determined in respect of April 1 exchange	$300,000
(6) Highest bracket amount of the X Corporation for 1941 (60 per cent of $300,000)	$180,000

SEC. 30.752–8. *Highest bracket amount of transferor and transferee for taxable year of exchange.—(a) General rule—Application of section 752 (b) (1) and (c) (1).*—The highest bracket amount both of a transferor and a transferee for the taxable year in which an exchange takes place is the average bracket amount for such year, computed by taking into account the highest bracket amount immediately preceding such exchange and the highest bracket amount computed for the next taxable year with respect to such exchange. Such average is—

(1) The highest bracket amount immediately preceding the exchange, multiplied by the number of days in the taxable year up to and including the day of the exchange, plus

(2) The highest bracket amount for the next taxable year computed with respect to such exchange, multiplied by the number of days in the taxable year remaining after the day of the exchange,

divided by the number of days in the taxable year. For the purposes of this section, in the case of a transferee, the term "exchange" includes a section 112(b)(6) liquidation of the character described in section 752(c)(5) and is deemed to have taken place on the day the liquidation is completed. The highest bracket amount immediately prior to an exchange, of a transferee organized upon such exchange, is $500,000, and the taxable year of such a transferee is the period from the date of its organization to the end of its first accounting period for which it files its return.

This paragraph may be illustrated by the following example:

Example: On July 1, 1940, the X Corporation, which makes its income tax returns on the calendar year basis and has not previously in 1940 been a party to an exchange, organizes the Y Corporation, to which it transfers property in exchange for all the stock of the Y Corporation. Under section 752(b)(2) and section 30.752–3(*a*) the highest bracket amount of the X Corporation for 1941 is $200,000. The highest bracket amount of the X Corporation for 1940 is therefore $350,000, computed as follows:

(1)	500,000 (highest bracket amount immediately preceding exchange) multiplied by 183 (number of days in 1940 up to and including July 1)	$91,500,000
(2)	Plus: $200,000 (highest bracket amount for 1941, computed in respect of July 1 exchange), multiplied by 183 (number of days July 2 to December 31, 1940, both inclusive)	36,600,000
(3)	Item (1) plus item (2)	128,100,000
(4)	Highest bracket amount for 1940 ($128,100,000 (item (3)) divided by 366 (number of days in 1940)	300,000

(*b*) *Where more than one exchange in taxable year—Application of section 752(d) (1) and (2).*—In the case of a transferor or a transferee which has been a party to more than one exchange in the same taxable year, its highest bracket amount for such taxable year is the amount computed under paragraph (*a*) of this section in respect of the last exchange, but in computing such amount previous exchanges must be taken into account in order to determine the various factors which enter into such computation. The highest bracket amount preceding such last exchange (which is the first factor) is the highest bracket amount for such taxable year computed under paragraph (*a*) of this section in respect of the next to last exchange as though such taxable year ended on the date of the last exchange. Thus, in the case of a calendar year corporation, which is a party to two exchanges in 1940, one on July 1 and one on October 1, the taxpayer must use as the highest bracket amount immediately preceding the October 1 exchange the highest bracket amount determined under paragraph (*a*) of this section relative to the July 1 exchange as though the taxable year ended October 1 rather than December 31. The highest bracket amount for the next taxable year (which is the second factor) is the amount computed under section 30.752–7, which takes into account previous exchanges.

This section may be illustrated by the following example:

Example: The X Corporation, which makes its income tax returns on a calendar year basis, is either a transferor or transferee in three exchanges during the year 1940, the first on March 1, the second on May 1, and the third on July 1. Preceding the first exchange its highest bracket amount is $500,000. Its highest bracket amount for the year 1941, computed in respect of such first exchange, is $400,000; computed in respect of the second exchange, it is $300,000; and, computed in respect of the last exchange, it is $150,000. (See section 30.752–7.) To compute the X Corporation's final highest bracket amount for 1940 it is necessary to begin with the first exchange, as follows:

(1)	$500,000 (highest bracket amount preceding first exchange), multiplied by 61 (number of days January 1 to March 1)	$30,500,000
(2)	$400,000 (highest bracket amount for 1941, computed in respect of March 1 exchange), multiplied by 61 (number of days March 2 to May 1)	24,400,000
(3)	Item (1) plus item (2)	54,900,000
(4)	Highest bracket amount immediately preceding May 1 exchange (item (3) divided by 122, number of days January 1 to May 1)	450,000

It is next necessary to make the same computation relative to the second, or May 1, exchange, as follows:

(5)	$450,000 (highest bracket amount immediately preceding May 1 exchange, *i. e.*, item (4)), multiplied by 122 (number of days January 1 to May 1)	$54,900,000
(6)	$300,000 (highest bracket amount for 1941, computed in respect of May 1 exchange), multiplied by 61 (number of days May 2 to July 1)	18,300,000
(7)	Item (5) plus item (6)	73,200,000
(8)	Highest bracket amount immediately preceding July 1 exchange (item (7) divided by 83, number of days January 1 to July 1)	400,000

The highest bracket amount immediately preceding the July 1 exchange having thus been determined, it is now possible to make a final determination of the highest bracket amount of the X Corporation for the year 1940. Such highest bracket amount is $275,000, computed as follows:

(9)	$400,000 (highest bracket amount immediately preceding July 1 exchange, *i. e.*, item (8)) multiplied by 183 (number of days January 1 to July 1)	$73,200,000
(10)	$150,000 (highest bracket amount for 1941, computed in respect of July 1 exchange), multiplied by 183 (number of days July 2 to December 31)	27,450,000
(11)	Item (9) plus item (10)	100,650,000
(12)	Highest bracket amount of the X Corporation for 1940 (item (11) divided by 366, number of days in 1940)	275,000

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved February 8, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register February 10, 1941, 9.23 a. m.)

INCOME TAX RULINGS.—PART I.

A. INTERNAL REVENUE CODE AND REVENUE ACTS OF 1939 AND 1940.

CHAPTER 1.—INCOME TAX.

SUBCHAPTER B.—GENERAL PROVISIONS.

PART I.—RATES OF TAX.

SECTION 13.—TAX ON CORPORATIONS IN GENERAL.

SECTION 19.13–5: Tax on corporations in general— Taxable years beginning after December 31, 1939. (Also Sections 19.13–6 and 19.13–7; Section 14, Section 19.14–2; Section 15, Section 19.15–1; and Section 362, Section 19.362–1.) 1941–7–10607 T. D. 5038

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 19.—INCOME TAX.

Regulations 103 amended to conform to section 101 of the Second Revenue Act of 1940.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

In order to conform Regulations 103 [Part 19, Title 26, Code of Federal Regulations, 1940 Sup.] to section 101 of the Second Revenue Act of 1940 (Public, No. 801, Seventy-sixth Congress, third session), approved October 8, 1940, such regulations are amended as follows:

PARAGRAPH 1. The following is inserted immediately preceding section 19.13–1:

SEC. 101. CORPORATION INCOME TAX. (Second Revenue Act of 1940.)

(a) TAX ON CORPORATIONS IN GENERAL.—Section 13(b) of the Internal Revenue Code, as amended by section 3 of the Revenue Act of 1940, is amended to read as follows:

"(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 22½ 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 $3.775, plus 35 per centum of the amount of the normal-tax net income in excess of $25,000."

* * * * *

(e) TAXABLE YEARS TO WHICH APPLICABLE.—Amendments made by this section shall be applicable only with respect to taxable years beginning after December 31, 1939.

PAR. 2. Section 19.13–5, as amended by Treasury Decision 5011, approved September 24, 1940 [C. B. 1940–2, 15], is amended by striking out in the last paragraph "$31,964.30" wherever it appears, and by inserting in lieu thereof "$38,565.89."

PAR. 3. Section 19.13–6, as amended by Treasury Decision 5011, is amended by striking out "19 per cent," "$31,964.30," "$17,385," and "17,385," wherever they appear, and by inserting in lieu thereof "22 1/10 per cent," "$38,565.89," "$20,221.50," and "20,221.50," respectively.

PAR. 4. Section 19.13–7, as amended by Treasury Decision 5011, is amended by striking out "33 per cent," "$31,964.30," "$4,154.50," "4,154.50," "19 per cent," and "4,968.50," wherever they appear, and by inserting in lieu thereof "35 per cent," "$38,565.89," "$4,177.50," "4,177.50," "22 1/10 per cent," and "5,779.15," respectively.

PAR. 5. The following is inserted immediately preceding section 19.14–1:

SEC. 101. CORPORATION INCOME TAX. (Second Revenue Act of 1940.)

* * * * * * *

(b) TAX ON FOREIGN CORPORATIONS.—Section 14(c)(1) of the Internal Revenue Code, as amended by section 3 of the Revenue Act of 1940, is amended to read as follows:

"(c) FOREIGN CORPORATIONS.—

"(1) In the case of a foreign corporation engaged in trade or business within the United States or having on office or place of business therein, the tax shall be an amount equal to 22 1/10 per centum of the normal-tax net income, regardless of the amount thereof."

* * * * *

(e) TAXABLE YEARS TO WHICH APPLICABLE.—Amendments made by this section shall be applicable only with respect to taxable years beginning after December 31, 1939.

PAR. 6. Section 19.14–2, as amended by Treasury Decision 5011, is amended by striking out in the first sentence of the last paragraph "19 per cent" and by inserting in lieu thereof "22 1/10 per cent."

PAR. 7. The following is inserted immediately preceding section 19.15–1, as amended by Treasury Decision 5011:

SEC. 101. CORPORATION INCOME TAX. (Second Revenue Act of 1940.)

* * * * * * *

(d) DEFENSE TAX FOR FIVE YEARS.—The first sentence of section 15 of the Internal Revenue Code, added to such Code by section 201 of the Revenue Act of 1940, is amended to read as follows: "In the case of any taxpayer, the amount of tax under this chapter for any taxable year beginning after December 31, 1939, and before January 1, 1945, shall be the tax computed without regard to this section, increased by 10 per centum; except that in the case of a corporation the increase shall be limited to 10 per centum of the tax computed without regard to the amendments made by section 101 (a), (b), and (c) of the Second Revenue Act of 1940."

PAR. 8. The first paragraph of section 19.15–1, as amended by Treasury Decision 5011, is stricken out, and there is inserted in lieu thereof the following:

SEC. 19.15–1. *Defense tax.*—For taxable years beginning after December 31, 1939, and before January 1, 1945, the tax computed in accordance with Chapter 1 of the Internal Revenue Code as amended without regard to section 15 (added by section 201 of the Revenue Act of 1940[1] and amended by section 101(d) of the

[1] Section 201 of the Revenue Act of 1939 amended sections 13, 14, and 15 by enacting new sections 13 and 14 imposing taxes on the income of corporations for taxable years beginning after December 31, 1939, and eliminating section 15. A new section 15, providing for a defense tax, was added by section 201 of the Revenue Act of 1940.

Second Revenue Act of 1940) is increased by 10 per cent thereof. For the purpose of this 10 per cent increase, the tax which is to be increased is computed before the application of the foreign tax credit and the credit for taxes withheld at the source. In the case of a corporation, this 10 per cent increase shall be computed upon the basis of the tax determined without regard to the amendments made by section 101 (a), (b), and (c) of the Second Revenue Act of 1940.

Example: The A Corporation, a domestic corporation, has for the calendar year 1940 a net income of $60,000, including interest on United States obligations (allowable as a credit under section 26(a)) in the amount of $3,000, and dividends received (of the class allowable as a credit under section 26(b)) in the amount of $10,000. The total tax upon the corporation is $11,640, computed as follows:

Net income	$60,000.00
Less interest on United States obligations	3,000.00
Adjusted net income	57,000.00
Less credit for dividends received (85 per cent of $10,000)	8,500.00
Normal-tax net income	48,500.00
Tax under section 13(b)(1) as amended by section 101(a) of the Second Revenue Act of 1940 (22$\frac{1}{10}$ per cent of $48,500)	10,718.50
Defense tax under section 15 (10 per cent of $9,215, tax computed under section 13(b)(1) without regard to the amendment by section 101(a) of the Second Revenue Act of 1940 (19 per cent of $48,500))	921.50
Total tax	11,640.00

Section 15 as amended by section 101 of the Second Revenue Act of 1940 provides that the defense tax shall be based upon the normal tax computed at rates provided by section 13(b) prior to its amendment by section 101 of the Second Revenue Act of 1940. Although, by reason of the alternative tax provisions, the normal-tax net income must amount to $38,565.89 before the new normal tax rate of 22.1 per cent is applicable, the old normal tax rate of 19 per cent was applicable if the normal-tax net income amounted to $31,964.30. Therefore, in the case of normal-tax net incomes between $31,964.30 and $38,565.89, the defense tax will be based on the 19 per cent rate though the permanent normal tax is based on the graduated rates of the alternative tax. The normal tax rates both before and after the application of the defense tax may be illustrated by the following table:

	Permanent rate.	Temporary additional rate (defense tax).	Total normal-tax rate.
Corporations with normal-tax net incomes not in excess of $31,964.30:	*Per cent.*	*Per cent.*	*Per cent.*
First $5,000	13.50	1.35	14.85
Next $15,000	15.00	1.50	16.50
Next $5,000	17.00	1.70	18.70
Next $6,964.30	35.00	3.30	38.30
Corporations with normal-tax net incomes in excess of $31,964.30 but not in excess of $38,565.89:			
First $5,000	13.50	1.90	15.40
Next $15,000	15.00	1.90	16.90
Next $5,000	17.00	1.90	18.90
Next $13,565.89	35.00	1.90	36.90
Corporations with normal-tax net incomes in excess of $38,565.89	22.10	1.90	24.00

PAR. 9. The following is inserted immediately preceding section 19.362–1, as amended by Treasury Decision 5011:

SEC. 101. CORPORATION INCOME TAX. (Second Revenue Act of 1940.)

* * * * * * *

(c) TAX ON MUTUAL INVESTMENT COMPANIES.—Section 362(b) of the Internal Revenue Code, as amended by section 3 of the Revenue Act of 1940, is amended to read as follows:

"(b) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year upon the Supplement Q net income of every

mutual investment company a tax equal to 22½ per centum of the amount thereof."

* * * * * * *

(e) TAXABLE YEARS TO WHICH APPLICABLE.—Amendments made by this section shall be applicable only with respect to taxable years beginning after December 31, 1939.

PAR. 10. Section 19.362–1, as amended by Treasury Decision 5011, is amended by striking out in the first sentence " 19 per cent " and by inserting in lieu thereof " $22\frac{1}{10}$ per cent."

(This Treasury decision is issued under the authority contained in section 101 of the Second Revenue Act of 1940 (Public, No. 801, Seventy-sixth Congress, third session) and section 62 of the Internal Revenue Code (53 Stat., 32).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved February 8, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register February 11, 1941, 11.50 a. m.)

SECTION 19.13–6: Tax under general rule—Taxable years beginning after December 31, 1939.

INTERNAL REVENUE CODE.

Regulations 103, amended. (See T. D. 5038, page 187.)

SECTION 19.13–7: Alternative tax (corporations with normal-tax net incomes slightly more than $25,000)—Taxable years beginning after December 31, 1939.

INTERNAL REVENUE CODE.

Regulations 103, amended. (See T. D. 5038, page 187.)

SECTION 14.—TAX ON SPECIAL CLASSES OF CORPORATIONS.

SECTION 19.14–2: Tax on special corporations—Taxable years beginning after December 31, 1939.

INTERNAL REVENUE CODE.

Regulations 103, amended. (See T. D. 5038, page 187.)

SECTION 15.—DEFENSE TAX FOR FIVE YEARS.

SECTION 19.15–1: Defense tax.

INTERNAL REVENUE CODE.

Regulations 103, amended. (See T. D. 5038, page 187.)

SECTION 19.15-1: Defense tax. 1941-17-10693
(Also Section 56, Section 19.56-1.) I. T. 3470

INTERNAL REVENUE CODE.

Where the foreign tax credit to which a taxpayer is entitled equals the total amount of the normal tax, surtax, and defense tax liability, no defense tax is due. This rule is equally applicable where the amount of tax paid at the source equals or exceeds the total normal tax, surtax, and defense tax liability.

Advice is requested whether A is liable for a defense tax amounting to x dollars, notwithstanding the fact that her income tax return for the year 1940 shows that she is entitled to a foreign tax credit equal to the total taxes—normal tax, surtax, and defense tax—shown to be due on her return.

The return filed by A for the year 1940 shows an income tax liability of $10x$ dollars (line 31, page 1, on Form 1040) based on income derived entirely from sources within a possession of the United States. The defense tax liability is, therefore, x dollars, that is, 10 per cent of $10x$ dollars, which tax plus the tax liability of $10x$ dollars shown on line 31 of Form 1040 does not exceed the foreign tax credit to which A is entitled. It is contended that the foreign tax credit is deductible as a credit against the normal tax, surtax, and defense tax, and, therefore, A is not liable for the payment of any tax whatever for the year 1940.

Section 201 of the Revenue Act of 1940 amended the Internal Revenue Code by the insertion after section 14 of the Code of section 15, "Defense Tax for Five Years," which provides in part that:

* * * For the purposes of this section, the tax computed without regard to this section shall be such tax before the application of the credit provided in section 31 ("foreign tax credit"), and the credit provided in section 32 (taxes withheld at the source).

It is held that A is not liable for the payment of the defense tax of x dollars since the foreign tax credit to which she is entitled under section 131 of the Internal Revenue Code equals the total amount of the normal tax, surtax, and defense tax liability shown on her return. This ruling is equally applicable to those cases where the tax paid at the source is in excess of the total amount of the normal tax, surtax, and defense tax.

PART II.—COMPUTATION OF NET INCOME.

SECTION 22(a).—GROSS INCOME: GENERAL DEFINITION.

SECTION 19.22(a)-1: What included in gross income. 1941-6-10588
I. T. 3447

INTERNAL REVENUE CODE.

Insurance benefit payments made to individuals under section 202 (a), (b), (c), (d), (e), (f), and (g), Title II of the Social Security Act, as amended, are not subject to the Federal income tax in the hands of the recipients.

Advice is requested whether the monthly payments made under the provisions of section 202 of Title II of the Social Security Act,

as amended by the Social Security Act Amendments of 1939 (53 Stat., 1360), under which such payments are to begin in 1940 instead of in 1942 as originally provided are subject to the Federal income tax.

Effective as of January 1, 1940, there was created under section 201(a) of Title II, as amended, on the books of the Treasury of the United States, a trust fund to be known as the "Federal Old-Age and Survivors Insurance Trust Fund," and all amounts credited thereto are made available for the payment of the insurance benefits specified under section 202 as amended.

The old-age and survivor's insurance benefit payments thus provided for include the primary insurance benefits as set forth or defined in section 202(a); wife's insurance benefits, defined in section 202(b); child's insurance benefits, defined in section 202(c); widow's insurance benefits, defined in section 202(d); widow's current insurance benefits, defined in section 202(e); parent's insurance benefit, defined in section 202(f); and the lump-sum death payments, as stated in section 202(g).

It is held that the sundry insurance benefit payments made to individuals under section 202 (a), (b), (c), (d), (e), (f), and (g), Title II of the Social Security Act, as amended by the Social Security Act Amendments of 1939, are not subject to Federal income tax in the hands of the recipients.

SECTION 19.22(a)-2: Compensation for personal services. 1941-19-10704 I. T. 3473

INTERNAL REVENUE CODE.

The enlistment allowance provided for in section 9 of the basic pay Act of June 10, 1922 (42 Stat., 625), paid to honorably discharged enlisted men of the Army and Marine Corps is a bonus or additional compensation paid for reenlistment and is subject to Federal income tax.

Advice is requested as to the taxable status of the enlistment allowance paid upon reenlistment to honorably discharged men of the Army and Marine Corps.

Section 9 of the basic pay Act of June 10, 1922 (42 Stat., 625), after specifying the monthly base pay of the respective classes and grades of warrant officers and enlisted men of the Army and Marine Corps, provides in part as follows:

* * * On and after July 1, 1922, an enlistment allowance equal to $50, multiplied by the number of years served in the enlistment period from which he has last been discharged, shall be paid to every honorably discharged enlisted man of the first three grades who reenlists within a period of three months from the date of his discharge, and an enlistment allowance of $25, multiplied by the number of years served in the enlistment period from which he has last been discharged, shall be paid to every honorably discharged enlisted man of the other grades who reenlists within a period of three months from the date of his discharge. * * *

The enlistment allowance is a bonus or additional compensation paid for reenlistment, the amount of such payment being measured by the length of previous service. It is held, therefore, that the enlistment allowance in question is subject to Federal income tax.

SECTION 19.22(a)–3: Compensation paid other than in cash. 1941–10–10625 I. T. 3455

INTERNAL REVENUE CODE.

The allowance made by the United States under the Act of May 14, 1940 (Public, No. 511, Seventy-sixth Congress), to officers of the Officers' Reserve Corps of the Army for uniforms and equipment is not subject to Federal income tax.

Advice is requested whether the allowance by the United States to officers of the Officers' Reserve Corps under the Act of May 14, 1940 (Public, No. 511, Seventy-sixth Congress), for uniforms and equipment is taxable income to the recipient.

The Act in question is entitled "An Act to provide allowances for uniforms and equipment for certain officers of the Officers' Reserve Corps of the Army," and reads as follows:

That officers of the Officers' Reserve Corps of the Army shall be entitled to an allowance for uniforms and equipment of $50 per annum upon completion, in separate fiscal years, of each of their first three periods of active-duty training of three months or less, following their original appointment, during which periods the uniform is required to be worn.

The War Department, Congress, and the courts have recognized a distinction between pay and allowances. As a result of the decision in *Clifford Jones* v. *United States* (60 Ct. Cls., 552, T. D. 3724, C. B. IV–2, 136 (1925)), allowances to Army officers for subsistence and quarters are not subject to Federal income tax. The allowance for uniforms and equipment in the instant case falls within the same category as an allowance for subsistence or quarters, inasmuch as it is furnished not as compensation but to promote the due performance of the officers' military duty.

It is held, therefore, that the allowance in question provided to officers of the Officers' Reserve Corps of the Army for uniforms and equipment is not subject to Federal income tax.

SECTION 19.22(a)–14: Cancellation of indebtedness. 1941–8–10609 G. C. M. 22528
(Also Section 112(a), Section 19.112(a)–1.)

INTERNAL REVENUE CODE.

Method of determining the amount of cancellation of indebtedness, within the purview of section 270 of the Bankruptcy Act, as amended, obtained by the M Company as the result of its reorganization pursuant to the plan under which new bonds plus first preferred stock were exchanged for old bonds, new bonds plus second preferred stock were exchanged for notes, and new common stock was issued in payment of arrears of interest on the old obligations.

An opinion is requested as to the method of determining the amount of cancellation of indebtedness, as contemplated in section 270 of the Bankruptcy Act, as amended, obtained by the M Company as the result of its reorganization under the circumstances herein set forth.

Section 270 of the Bankruptcy Act, as added by the Chandler Act of June 22, 1938 (52 Stat., 840), and amended by Act of July 1, 1940

(54 Stat., 709; Public, No. 699, Seventy-sixth Congress, third session, C. B. 1940–2, 598), provides as follows:

SEC. 270. In determining the basis of property for any purposes of any law of the United States or of a State imposing a tax upon income, the basis of the debtor's property (other than money) or of such property (other than money) as is transferred to any person required to use the debtor's basis in whole or in part shall be decreased by an amount equal to the amount by which the indebtedness of the debtor, not including accrued interest unpaid and not resulting in a tax benefit on any income tax return, has been canceled or reduced in a proceeding under this chapter, but the basis of any particular property shall not be decreased to an amount less than the fair market value of such property as of the date of entry of the order confirming the plan. Any determination of value in a proceeding under this chapter shall not be deemed a determination of fair market value for the purposes of this section. The Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe such regulations as he may deem necessary in order to reflect such decrease in basis for Federal income-tax purposes and otherwise carry into effect the purposes of this section.

That section, it will be observed, provides that the basis of the debtor's property, or property transferred to one required to use the debtor's basis, shall be decreased by the amount by which the indebtedness of the debtor has been canceled or reduced in a corporate reorganization in proceedings under the Bankruptcy Act. The question is presented as to what constitutes a cancellation of indebtedness and, specifically, whether or not the receipt by (1) an open account creditor, (2) a note holder, or (3) a bondholder of a token in substitution for the debt always constitutes an exchange rather than a cancellation of indebtedness; also, if such a receipt ever constitutes a cancellation of indebtedness, the approximate amount that should be considered a token payment.

The debt and capital structure of the M Company before reorganization under section 77B of the Bankruptcy Act was:

(*a*) 6½ per cent 15-year gold bonds	$1,000,000
Unpaid interest	400,000
(*b*) 7 per cent 10-year gold notes	300,000
Unpaid interest	125,000

(*c*) 19,000 shares $7 no par preferred stock.
(*d*) 115,000 shares no par common stock.

For each $1,000 of the gold bonds indicated in (*a*) above, the plan of reorganization called for the issuance of one $700 4 per cent bond and six shares of first preferred no par stock entitled to $50 a share on liquidation. This transaction, in the opinion of this office, represents an exchange which so far as the corporate debtor was concerned represented to the extent of $700 of face amount of the $1,000 gold bond a substitution of indebtedness of an equal amount evidenced by the new 4 per cent bond. With respect to the remaining $300 of the face amount of such a gold bond, the transaction represented to the corporate debtor the receipt by way of an exchange of an addition to its capital to the extent of the fair market value of the six shares of first preferred no par stock at the time such shares became effective stock on the date of the entry of the order confirming the plan of reorganization. Any difference between the remaining $300 of the face amount of such gold bond and such fair market value of the six shares of stock represents a cancellation of the indebtedness of the corporate debtor, and is the amount to be used in the reduction of

the basis of the debtor's property under section 270 of the Chandler Act amendments to the Bankruptcy Act, as further amended by the Act of Congress approved July 1, 1940, supra, provided, however, that this adjustment shall not in any event reduce the basis of the debtor's property below its fair market value at the date of the exchange.

The plan of reorganization called for the issuance in respect of each $1,000 of the gold notes described in (*b*) above of 20 shares of second preferred no par stock entitled to $50 a share in liquidation after the prior liquidation of the first preferred stock. As already indicated in the preceding paragraph, this transaction is deemed by this office to represent an exchange which to the corporate debtor represented a receipt by it as an addition to its capital of an amount equal to the fair market value of the 20 shares of second preferred no par stock on the date of the entry of the order of confirmation of the plan of reorganization. The difference between the $1,000 face amount of each such gold note and such fair market value of the 20 shares of stock represents a cancellation of indebtedness within the meaning of section 270, supra. The reduction of basis on account of cancellation is subject to the limitation pointed out at the end of the preceding paragraph.

The plan also called for the issuance of one share of new no par common stock for each $100 of past due interest in respect of both the bonds and notes. The issuance of the one share of stock in this connection is considered to represent a payment of the past due interest to the extent of the fair market value of the stock (determined as of the time indicated in the two preceding paragraphs), and a cancellation of indebtedness for the purposes of section 270, supra, as to the balance of such interest. However, no reduction of basis is, under said section, to be made on account of accrued unpaid interest which did not result in a tax benefit to the corporate debtor on any income tax return.

It does not appear that open account creditors are involved in this particular reorganization, but it is the opinion of this office that if such a creditor participates in a plan of reorganization in a manner similar to the holders of the gold bonds and the gold notes here involved, the conclusions reached herein would be applicable.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

SECTION 22(b).—GROSS INCOME: EXCLUSIONS FROM GROSS INCOME.

SECTION 19.22(b)(4)–4: Interest upon United States obligations. 1941–10–10631 T. D. 5040

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 19.—INCOME TAX.

Amending sections 19.22(b)(4)–4 and 19.22(b)(4)–6 of Regulations 103, relating to exemption of interest upon United States obligations.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

PARAGRAPH 1. The following is inserted immediately preceding section 19.22(b)(4)-1 of Regulations 103 [Part 19, Title 26, Code of Federal Regulations, 1940 Sup.]:

PUBLIC DEBT ACT OF 1941 (approved February 19, 1941).

* * * * * * *

SEC. 4. (a) Interest upon, and gain from the sale or other disposition of, obligations issued on or after the effective date of this Act by the United States or any agency or instrumentality thereof shall not have any exemption, as such, and loss from the sale or other disposition of such obligations shall not have any special treatment, as such, under Federal tax Acts now or hereafter enacted; except that any such obligations which the United States Maritime Commission or the Federal Housing Administration has, prior to the effective date of this Act, contracted to issue at a future date, shall when issued bear such tax-exemption privileges as were, at the time of such contract, provided in the law authorizing their issuance. For the purposes of this subsection a Territory, a possession of the United States, and the District of Columbia, and any political subdivision thereof, and any agency or instrumentality of any one or more of the foregoing, shall not be considered as an agency or instrumentality of the United States.

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

SEC. 5. This Act, except sections 2 (b) and (c), shall become effective on the first day of the month following the date of its enactment.

PAR. 2. Section 19.22(b)(4)-4 of Regulations 103 is amended—

(1) by changing the caption thereof to read as follows: "*Interest upon United States obligations.*—(*a*) *Issued prior to March 1, 1941.*"

(2) by inserting in the last paragraph thereof after the word "deposited" the words "prior to March 1, 1941".

(3) by inserting at the end thereof the following:

(*b*) *Issued on or after March 1, 1941.*—By virtue of the provisions of sections 4 and 5 of the Public Debt Act of 1941, the exemption prescribed in subsection (*a*) of this section of these regulations is limited to such bonds, notes, or certificates of indebtedness as have been issued prior to March 1, 1941. Under such provisions of the Public Debt Act of 1941, interest upon obligations issued on or after March 1, 1941, by the United States, or any agency or instrumentality thereof, shall not have any exemption, as such, from Federal tax now or hereafter imposed except in respect of any such obligations which the United States Maritime Commission or the Federal Housing Administration has, prior to March 1, 1941, contracted to issue at a future date. The interest on such obligations so contracted to be issued shall bear such tax-exemption privileges as were at the time of such contract provided in the law authorizing their issuance. For the purposes hereof, under section 4(a) of the Public Debt Act of 1941, a Territory, a possession of the United States, and the District of Columbia and any political subdivisions thereof, and any agency or instrumentality of any one or more of the foregoing, shall not be considered as an agency or instrumentality of the United States.

PAR. 3. Section 19.22(b)(4)-6 of Regulations 103 is amended to read as follows:

SEC. 19.22(b)(4)-6. *Interest upon United States obligations in the case of nonresident aliens and foreign corporations, not engaged in business in the United States.*—By virtue of section 4 of the Victory Liberty Loan Act of March 3, 1919, 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, if such individual, corporation, partnership, or association is not engaged in business in the United States, is exempt from income taxes. Such exemption applies only to such bonds, notes, or certificates as have been issued prior to March 1, 1941. Interest derived by a nonresident alien individual, or by a foreign corporation, partnership, or association on such bonds, notes, or certificates issued on or after March 1, 1941, is subject to tax as in the case of taxpayers generally as provided in section 19.22(b)(4)–4(*b*).

(This Treasury decision is issued under the authority contained in sections 4 and 5 of the Public Debt Act of 1941 (Public Law 7, Seventy-seventh Congress) and section 62 of the Internal Revenue Code (53 Stat., 32 (26 U. S. C., Sup. V, 62)).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved February 28, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register March 3, 1941, 3.52 p. m.)

SECTION 19.22(b)(4)–4: Interest upon United States obligations. 1941–14–10665 Mim. 5184

Taxable and exempt status under Federal income tax laws of interest on United States savings bonds issued (1) prior to March 1, 1941, and (2) on and after March 1, 1941.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C., March 21, 1941.

Collectors of Internal Revenue, Internal Revenue Agents in Charge, and Others Concerned:

INCREMENT IN VALUE AS INTEREST.

1. The issuance of United States savings bonds is authorized by the Second Liberty Bond Act of 1917, as amended. For the purpose of determining taxes and tax exemption, the law provides that the increment in value represented by the difference between the price paid for United States savings bonds and the redemption value received therefor (whether at or before maturity) shall be considered as interest.

UNITED STATES SAVINGS BONDS ISSUED PRIOR TO MARCH 1, 1941.

2. Under existing law interest on United States savings bonds issued prior to March 1, 1941, is exempt from income or profits taxes now or hereafter imposed by the United States except surtaxes, excess profits and war profits taxes; and is exempt from such excepted taxes to the extent of interest on a principal amount of bonds not in excess of $5,000 (including other bonds owned by the taxpayer which were issued under the authority of the Second Liberty Bond Act, as

amended). There is no war profits tax now imposed by the United States to which such interest is subject. The declared value excess profits tax and the excess profits tax now imposed by the United States and to which such interest is subject are applicable only to corporations.

SELECTION OF BONDS.

3. Taxpayers may select each year the bonds issued prior to March 1, 1941, comprising the principal amount of $5,000, the interest from which they desire to treat as tax-exempt income for the year under consideration. The bonds selected may therefore consist of United States savings bonds and Treasury bonds issued prior to March 1, 1941, all of which bonds were issued under the authority of the Second Liberty Bond Act, as amended.

4. In determining whether the said principal amount of such bonds issued prior to March 1, 1941, owned by a taxpayer is within or in excess of $5,000, the issue or purchase price only is considered as principal of United States savings bonds and not the maturity value.

UNITED STATES SAVINGS BONDS ISSUED ON AND AFTER MARCH 1, 1941.

5. Under the provisions of the Public Debt Act of 1941, interest on United States savings bonds issued on and after March 1, 1941, is not exempt from income or profits taxes now or hereafter imposed by the United States.

METHOD OF REPORTING INTEREST.

6. Every person owning United States savings bonds is required by law to submit in his Federal income tax return a statement showing the amount of such obligations owned by him and the income received therefrom.

7. Taxpayers who regularly employ the cash receipts and disbursements method of accounting should return the interest (increment in value) on United States savings bonds as income (taxable or exempt), for Federal income or profits tax purposes, for the tax year in which payment of the redemption value of the bonds is received (whether before or at maturity); provided, however, that in the case of the death of a taxpayer the interest (increment in value) earned up to the date of his death shall be returned as income for the taxable period in which falls the date of his death.

8. Taxpayers who regularly employ the accrual method of accounting should return the interest (increment in value) on United States savings bonds as income (taxable or exempt), for Federal income or profits tax purposes, for each tax year when and to the extent that it is earned during the year according to the terms of the bonds and in the amount indicated in the table of redemption values shown thereon.

9. Mimeograph 5166, dated February 14, 1941, is revoked. Inquiries regarding this mimeograph should refer to the number thereof and the symbols IT:TM.

TIMOTHY C. MOONEY,
Acting Commissioner.

SECTION 19.22(b)(4)-4: Interest upon United States obligations. 1941-20-10715
(Also Section 19.22(b)(4)-6; Section 24; Section 116.) I. T. 3475

INTERNAL REVENUE CODE.

Status for Federal income tax purposes of interest on and gain or loss from the sale or other disposition of "National Defense Series" Treasury bills and notes issued under the Second Liberty Bond Act, as amended by the Revenue Act of 1940.

Inquiry has been made relative to the status for Federal income tax purposes of interest on and gain or loss from the sale or other disposition of "National Defense Series" obligations of the United States, issued under the authority of section 21 of the Second Liberty Bond Act, as amended by section 302 of the Revenue Act of 1940, approved June 25, 1940.[1] (Act approved September 24, 1917, ch. 56, section 21, as added February 4, 1935, ch. 5, section 5, 49 Stat., 21; amended May 26, 1938, ch. 285, section 2, 52 Stat., 447; further amended July 20, 1939, ch. 336, 53 Stat., 1071; U. S. C., Title 31, section 757b; further amended June 25, 1940, section 302, Revenue Act of 1940, 54 Stat., 526, C. B. 1940-2, 447.)

(1) Interest on and gain from the sale or other disposition of "National Defense Series" Treasury *bills* are wholly exempt from all taxes now or hereafter imposed upon income or profits by the United States, any State, or any of the possessions of the United States, or by any local taxing authority thereof, and no loss from the sale or other disposition of such bills is allowable as a deduction, or otherwise recognizable, for the purposes of any tax now or hereafter imposed by the United States or any of its possessions. The amount of the discount at which the bills are originally sold by the United States is considered to be interest. (Section 5 (b) and (d) of the Second Liberty Bond Act, as amended and here effective;[1] Act approved September 24, 1917, ch. 56, section 5, 40 Stat., 290; amended April 4, 1918, ch. 44, section 4, 40 Stat., 504; further amended March 3, 1919, ch. 100, section 3, 40 Stat., 1311; further amended June 17, 1929, ch. 26, 46 Stat., 19; further amended June 17, 1930, ch. 512, 46 Stat., 775; further amended February 4, 1935, ch. 5, sections 2 and 3, 49 Stat., 20; U. S. C., Title 31, section 754.)

(2) Interest on "National Defense Series" Treasury *notes* which have been issued is wholly exempt from all taxes now or hereafter imposed upon income and profits by any State or any of the possessions of the United States, or by any local taxing authority thereof, but, except as stated in paragraph (3) below, is not wholly or partially exempt from any income, excess-profits, and war-profits taxes now or hereafter imposed by the United States, including normal taxes and surtaxes. (Section 18(b)(4) of the Second Liberty Bond Act, as amended and here effective;[1] Act approved September 24, 1917, ch. 56, section 18, as added March 3, 1919, ch. 100, section 1, 40 Stat., 1309; amended November 23, 1921, ch. 136, section 1401, 42 Stat., 321; further amended January 30, 1934, ch. 6, section 14(a)(3), 48 Stat., 343; and

[1] Further amended or supplemented, effective March 1, 1941, by the Public Debt Act of 1941, approved February 19, 1941 (page 546, this Bulletin); but such amendments or supplements are not applicable to the "National Defense Series" obligations here involved, which were issued prior to March 1, 1941.

further amended February 4, 1935, ch. 5, section 4, 49 Stat., 20; U. S. C., Title 31, section 753.) Gain or loss from the sale or other disposition of the notes is recognized and is includible in or deductible from gross income under and subject to the applicable provisions of the Internal Revenue Code, as amended.

(3) Interest on such "National Defense Series" Treasury *notes* while beneficially owned by a nonresident alien individual, or a foreign corporation, partnership, or association, if such individual, corporation, partnership, or association is not engaged in business in the United States, is wholly exempt from all taxes now or hereafter imposed upon income or profits by the United States, any State, or any of the possessions of the United States, or by any local taxing authority thereof. (Section 3 of the Fourth Liberty Bond Act, as amended by section 4 of the Victory Liberty Loan Act, approved March 3, 1919, and here effective;[1] Act approved July 9, 1918, ch. 142, section 3, 40 Stat., 845; amended March 3, 1919, ch. 100, section 4, 40 Stat., 1311; U. S. C., Title 31, section 750.) (See section 19.22(b)(4)-6 of Regulations 103, as amended by Treasury Decision 5040, approved February 28, 1941 (page 195, this Bulletin).)

SECTION 19.22(b)(4)-6: Interest upon United States obligations in the case of nonresident aliens and certain foreign organizations.

INTERNAL REVENUE CODE.

Regulations 103, amended. (See T. D. 5040, page 195.)

SECTION 19.22(b)(4)-6: Interest upon United States obligations in the case of nonresident aliens and certain foreign organizations.

INTERNAL REVENUE CODE.

Interest on "National Defense Series" obligations. (See I. T. 3475, page 199.)

SECTION 22(c).—GROSS INCOME: INVENTORIES.

SECTION 19.22(c)-8: Inventories of retail merchants. 1941-23-10740 T. D. 5048

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PARTS 3, 9, AND 19.—INCOME TAX.

Regulations 103, 101, 94, and 86, amended.—Inventories of retail merchants.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

Section 19.22(c)-8 of Regulations 103 [Part 19, Title 26, Code of Federal Regulations, 1940 Sup.], article 22(c)-8 of Regulations 101

[1] See footnote on page 199.

[Part 9, Title 26, Code of Federal Regulations, 1939 Sup.], article 22(c)-8 of Regulations 94 [Part 3, Title 26, Code of Federal Regulations], and article 22(c)-8 of Regulations 86, are amended by adding at the end thereof the following:

A taxpayer who previously has determined inventories in accordance with the foregoing, except that, to obtain a basis of approximate cost or market, whichever is lower, the practice has been followed, consistently and uniformly, of adjusting the retail selling prices of the goods included in the opening inventory and purchased during the year for mark-ups but not for mark-downs, may continue such practice subject to the conditions herein prescribed. The adjustments must be bona fide and consistent and uniform. Where mark-downs are not included in the adjustments, mark-ups made to cancel or correct mark-downs shall not be included; and the mark-ups included must be reduced by the mark-downs made to cancel or correct such mark-ups.

In no event shall mark-downs not based on actual reduction of retail sales prices, such as mark-downs based on depreciation and obsolescence, be recognized in determining the retail selling prices of the goods on hand at the end of the year.

Section 19.22(c)-8 of Regulations 103 is further amended by inserting, immediately following the concluding paragraph of the amendatory matter above set forth, an additional paragraph reading as follows:

A taxpayer who previously has determined inventories without following the practice of eliminating mark-downs in making adjustments to retail selling prices, may adopt such practice, provided permission to do so is obtained in accordance with, and subject to the terms provided by, section 19.41-2. A taxpayer filing a first return of income may adopt such practice subject to approval by the Commissioner upon examination of the return.

(This Treasury decision is prescribed pursuant to sections 22(c) and 62 of the Internal Revenue Code (53 Stat., 11, 32), and sections 22(c) and 62 of the Revenue Acts of 1938, 1936, and 1934 (52 Stat., 459, 480, 49 Stat., 1658, 1673, 48 Stat., 688, 700; 26 U. S. C., 22, 62, and Sup.).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved June 2, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register June 2, 1941, 12.08 p. m.)

SECTION 22(d).—GROSS INCOME: INVENTORIES—ELECTIVE METHOD.

SECTION 19.22(d)-1: Inventories under elective method. 1941-10-10626 I. T. 3456

INTERNAL REVENUE CODE.

Explanation of several provisions of the income tax regulations with respect to the use of the "last in, first out" method of valuing inventories for Federal income tax purposes permissible in certain industries under section 22(d) of the Internal Revenue Code.

Advice is requested with respect to a number of questions relating to the so-called "last in, first out" method of valuing inventories for Federal income tax purposes as permitted in certain industries by section 22(d) of the Internal Revenue Code, reference being made to

several provisions of the income tax regulations which are stated to require clarification.

In order more clearly to understand the provisions prescribed by the regulations, it is important that the general purpose or legislative scheme of the Act be borne in mind and that the regulations be given their natural meaning within the scope of such statutory purpose.

The first two questions relate to the provisions of section 19.22(d)-2 of Regulations 103, concerning the requirements incident to adoption and use of the so-called elective inventory method.

It is to be observed that the income tax regulations issued under the Internal Revenue Code recognize various methods of computing income for income tax purposes, and that even under the accrual method of computing income the regulations promulgated with respect to section 22(c) of the Code recognize inventories at cost, at cost or market, whichever is lower, at market value, by the "farm price method," by the "retail method," etc., and section 22(d) makes available to tanners and to producers and processors of certain nonferrous metals an elective method of inventorying raw materials which because of intermingling could not be identified with specific invoices. It is also to be observed that section 22(d) of the Code, prior to its amendment by section 219 of the Revenue Act of 1939, required all inventories of such materials to 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; that the change to such method should be made in accordance with such regulations as were properly prescribed as necessary to prevent the avoidance of tax; and that the regulations in question (article 22(d)-3, Regulations 101) required of the taxpayer an agreement to make such adjustments and to pay such taxes with respect to such adjustments "in the inventories of prior taxable years or otherwise, as the Commissioner deems necessary to prevent the change in method from resulting in avoidance of tax." The obvious purpose of the Act prior to its amendment was to require the use of inventories under the conditions described in section 22(c) of the Code and to require such inventories to be valued in accordance with the provisions contained in articles 22(c)-1 to 22(c)-8 of Regulations 101 (as made applicable to the Code by Treasury Decision 4885 (C. B. 1939-1 (Part 1), 396)), but to grant a taxpayer of the particular class described in section 22(d) the right of electing to use a fully described method of valuation with respect to a clearly defined portion of his inventory. In other words, the election granted by section 22(d) was in substance the privilege of lifting a portion of the inventory from the control of section 22(c) and the regulations thereunder without in any way affecting the remainder of the inventory.

Section 219 of the Revenue Act of 1939 not only amended section 22(d) of the Code and made such amendment applicable to taxable years beginning after December 31, 1938, but it also amended section 22(d) of the Revenue Act of 1938 to read as follows:

(d) If the inventory method described in section 22(d)(1), as amended, of the Internal Revenue Code is used for the first taxable year beginning after December 31, 1938, then, in determining income for the preceding taxable year, the closing inventory of such year of the goods specified in the application under section 22(d)(2), as amended, of such Code shall be at cost.

The amendment of section 22(d) of the Code reflects no change in the general purpose of the law other than to extend the right of election to all taxpayers required by section 22(c) to make inventories and to make the election applicable to all or any portion of such inventories.

On the basis of the foregoing, the following explanations are made:

(1) A taxpayer who adopts the "last in, first out" method for a specified portion of his inventory may continue to take the remainder of his inventory for tax purposes on a cost or market basis, or on any other basis which has been properly adopted for prior years and approved by the Commissioner; subject, however, to the requirement of section 19.22(d)–3 which reads as follows:

> 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.

Furthermore, attention is directed to the following language of section 19.22(c)–2:

> 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).* [Italics supplied.]

(2) If a taxpayer's manufacturing processes and accounting records are such as to permit a clear reflection of income by the use of inventories consisting of raw materials valued at cost by the "last in, first out" method and goods in process and finished goods valued at cost or market whichever is lower by the "first in, first out" method, then there is nothing in the law or regulations which would prohibit the use of the so-called elective inventory method in this manner.

(3) A taxpayer is not allowed to use as his opening inventory for goods under the "last in, first out" method the valuation used at the close of the preceding year without any adjustment, unless such closing inventory was properly taken at cost under the provisions of section 19.22(c)–3 of Regulations 103 and the corresponding article of prior regulations. Where the closing inventory of the preceding year was taken on any other basis (as, for instance, the basis of cost or market, whichever is lower, under section 19.22(c)–4), the opening inventory for goods under the "last in, first out" method must be adjusted to cost, and in addition the closing inventory of the preceding year must likewise be adjusted to cost in accordance with the rule prescribed by section 219(c) of the Revenue Act of 1939.

The agreement required by section 19.22(d)–4 of Regulations 103, as set forth by the application (Form 970 (revised)) for the adoption of the elective method, is as follows:

> The taxpayer hereby agrees to such adjustments incident to the change to the elective method, or to the use of such method, or to any later change from such method, in the inventories of prior taxable years or otherwise, as the Commissioner of Internal Revenue upon examination of the taxpayer's returns for the years involved may deem necessary in order that the true income of the taxpayer will be clearly reflected * * *.

As to its general application, the regulatory provision in question, supplemented by the agreement itself, would seem to require no clarification.

As to whether adjustments may be made only with respect to periods after the adoption of the elective method or with respect to prior taxable periods, all periods are covered by the regulations, whether before or after the adoption of the elective method. No situation is envisaged at present which would require adjustments of a period prior to the adoption of the elective method, other than the adjustment of the inventory of the last preceding year to actual cost. As to years for which assessment of additional taxes is barred by the statute of limitations, there is no requirement that the taxpayer waive the statute. However, if a correct reflection of income requires an adjustment to be made in a year for which assessment is barred, approval of the change to the elective method may be withheld and not granted except for a subsequent year.

(4) One of the inquiries refers to that portion of section 19.22 (d)–1 relating to the proper treatment of so-called firm purchase and sales contracts, and it is suggested that section 19.22(d)–1 seems to contemplate the pricing of firm purchase and sales contracts on the same basis as the remainder of the elective inventory, irrespective of their firm character. However, the regulations as to the treatment of firm purchase and sales contracts are clear. They provide that:

> 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.

If the conditions therein stated are complied with, the purchase and sales contracts may be included as a part of the inventory.

SECTION 19.22(d)–5: Revocation of election. 1941–20–10716
I. T. 3476

INTERNAL REVENUE CODE.

> The M Company is not precluded from adopting the elective method of inventory, provided in section 22(d)1 of the Internal Revenue Code, for the calendar year 1940 by reason of having submitted a financial report to a creditor covering the fiscal year ended May 31, 1940, in which report the elective method of inventory was not used.

Advice is requested whether the M Company is precluded from adopting the elective method of inventory for Federal income tax purposes for the calendar year 1940 by reason of having submitted a financial report to a creditor covering the fiscal year ended May 31, 1940, in which report the elective method of inventory was not used.

Section 22(d)2(B) of the Internal Revenue Code, as amended by section 219 of the Revenue Act of 1939, reads as follows:

> (2) The [elective] method described in paragraph (1) may be used—
> (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.

Section 19.22(d)-2(5), Regulations 103, reads as follows:

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;

The term "taxable year" is defined in section 48 of the Internal Revenue Code as follows:

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. "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.

Inasmuch as the period for which the financial report in question was made did not begin with or during the calendar year 1940, the use of such report does not preclude the adoption of the elective method of inventory for the calendar year 1940.

SECTION 23(a).—DEDUCTIONS FROM GROSS INCOME: EXPENSES.

SECTION 19.23(a)-1: Business expenses. 1941-8-10616
I. T. 3452

INTERNAL REVENUE CODE AND PRIOR REVENUE LAWS.

Unless a taxpayer's activities resulting in the production of taxable income constitute the carrying on of a trade or business, the ordinary and necessary expenses pertaining thereto are not deductible from gross income for Federal income tax purposes. I. T. 2751 (C. B. XIII-1, 43 (1934)), I. T. 2579 (C. B. X-2, 129 (1931)), and O. D. 877 (C. B. 4, 123 (1921)) revoked.

Inquiry has been made relative to the allowance under section 23(a) of the Internal Revenue Code of expenses incurred in the production of taxable income from sources other than the taxpayer's trade or business.

On February 3, 1941, the Supreme Court of the United States in *Higgins* v. *Commissioner* (61 S. Ct., 475, page 339, this Bulletin) affirmed the judgment of the Circuit Court of Appeals for the Second Circuit in that case (111 Fed. (2d), 795), and held that the taxpayer, who had extensive investments in real estate and income-producing securities, was not carrying on a trade or business within the meaning of section 23(a) of the Revenue Act of 1932 so far as his investments in stocks and bonds were concerned, and, therefore, was not entitled to deduct expenses incurred in connection with their handling. It was conceded that the taxpayer was engaged in business with respect to the

real estate which he owned. The Court held further that the expenses of the taxpayer's office which handled both his real estate and investment matters were capable of apportionment.

I. T. 2751 (C. B. XIII–1, 43 (1934)) holds (syllabus):

The ordinary and necessary expenses paid or incurred during the taxable year with respect to the management, protection, and conservation of properties producing taxable income are deductible from gross income.

I. T. 2579 (C. B. X–2, 129 (1931)) reads as follows:

If a safety deposit box is used primarily in connection with the safeguarding of income-producing securities the rent paid therefor would constitute a deductible business expense.

O. D. 877 (C. B. 4, 123 (1921)) reads as follows:

A taxpayer whose income is derived principally from investments in stocks and bonds may deduct as a business expense the rent of an office and the cost of clerical help if he can show in his return that such expense is ordinary and necessary within the meaning of section 214(a)1 of the Revenue Act of 1918.

The foregoing rulings are inconsistent with the decision in *Higgins v. Commissioner*, supra, and they are hereby revoked. Unless a taxpayer's activities resulting in the production of taxable income constitute the carrying on of a trade or business, the ordinary and necessary expenses pertaining thereto are not deductible from gross income for Federal income tax purposes.

SECTION 19.23(a)–1: Business expenses. 1941–6–10589
(Also Section 19.23(a)–2; Section 23(l), I. T. 3448
Section 19.23(l)–1.)

INTERNAL REVENUE CODE.

Deductibility for Federal income tax purposes of various expenses incurred by teachers in connection with their employment.

Advice is requested as to the deductibility for Federal income tax purposes of various expenses incurred by teachers in connection with their employment.

The dues paid by teachers to professional societies, the price of their subscriptions for educational journals connected with their profession, and the expenses of traveling and meals and lodging incurred in attending teachers' conventions in this country, if they are not reimbursed for such expenses, are considered ordinary and necessary business expenses and are deductible from their compensations as teachers in determining net income for Federal income tax purposes. Records of such expenditures must be kept to substantiate the deductions claimed.

The cost of technical books required by and purchased by teachers specifically for use in connection with their professional work is a capital expenditure which may be extinguished through annual deductions for depreciation.

SECTION 19.23(a)–2: Traveling expenses.

INTERNAL REVENUE CODE.

Teachers. (See I. T. 3448, above.)

SECTION 19.23(a)-2: Traveling expenses. 1941-19-10705
I. T. 3474

INTERNAL REVENUE CODE AND REVENUE ACT OF 1921.

A naval officer who is on permanent duty afloat and who maintains a home elsewhere may deduct as a business expense only that portion of the amount expended by him for subsistence as exceeds his money subsistence allowance, such allowance not being included in gross income. Such naval officer who does not maintain a home elsewhere is not entitled to a deduction for any part of the amount expended by him for subsistence.

I. T. 1497 (C. B. I-2, 89 (1922)) modified.

Reconsideration of the first issue presented in I. T. 1497 (C. B. I-2, 89 (1922)) has been requested.

In that ruling it was held in part that if a naval officer on permanent duty afloat is "away from home" he may deduct as a business expense the entire amount expended by him for subsistence.

Commissioned officers of the Navy on the active list are entitled at all times, in addition to pay, to a money allowance for subsistence. A naval officer on permanent duty afloat is not regarded by his department as being in a travel status and receives only a money subsistence allowance. Additional per diem or subsistence allowances are received when the officer is in a travel status.

Upon reconsideration of I. T. 1497, supra, it is held that a naval officer who is on permanent duty afloat (not a travel status) and who maintains a home elsewhere may deduct as a business expense only that portion of the amount expended by him for subsistence as exceeds his money subsistence allowance, such allowance not being included in gross income. Such an officer who does not maintain a home elsewhere is not entitled to a deduction for any part of the amount expended by him for subsistence.

I. T. 1497, supra, is modified accordingly.

SECTION 23(b).—DEDUCTIONS FROM GROSS INCOME: INTEREST.

SECTION 19.23(b)-1: Interest. 1941-25-10750
I. T. 3484

INTERNAL REVENUE CODE.

Deductibility of interest charged by a broker in connection with a loan on a marginal account where the taxpayer's (customer's) books are kept on the cash receipts and disbursements basis.

Advice is requested whether a taxpayer who keeps his books and files his Federal income tax returns on the cash receipts and disbursements basis is entitled to a deduction for interest charged by a stock broker for a loan on a marginal stock purchase where the dividends and other credits due him were not used to cover the interest charges but were paid to the taxpayer.

In the instant case, interest was charged each month to the taxpayer on the books of the broker and the increase in the debit balance of the taxpayer's marginal brokerage account at the end of the year was the amount of the interest charged to the account. The question

involved is whether the reduction of the taxpayer's equity in the securities held by the broker occasioned by the interest charges constitutes constructive payment of the interest.

Section 23(b) of the Internal Revenue Code reads as follows:

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.

Ordinarily, interest charged by a broker on a loan to a customer reduces any credit the customer may have which is otherwise available for withdrawal by him on the date on which the interest charge is made. When a customer's withdrawable credit is thus reduced at any time within the taxable year, payment of interest has been effected. If the withdrawable credit of the customer-taxpayer reporting income on the cash receipts and disbursements basis is insufficient to cover the entire interest charge, he is entitled to a deduction only to the extent that such credit offsets the interest charge. No deduction may be allowed for interest charges which have not been thus offset by withdrawable credit, regardless of the fact that on the date on which the interest charge is made, or at the end of the customer's taxable year, the then market value of collateral held by the broker may be sufficient to cover the amount of the loan owing to the broker plus the accrued interest thereon. The mere reduction in the taxpayer's equity in the securities held by the broker does not constitute constructive payment of the interest.

SECTION 23(c).—DEDUCTIONS FROM GROSS INCOME: TAXES GENERALLY.

SECTION 19.23(c)-1: Taxes. 1941-3-10564
I. T. 3441

INTERNAL REVENUE CODE.

The M Company, which failed to add to its sales prices during 1935, 1936, and 1937 and to collect from its vendees certain New York City sales taxes under the belief that such taxes were not due on the particular sales, may take the amounts thereof as deductions, for Federal income tax purposes, as business expenses, but not as taxes, in the year 1939, the year in which liability of the company was definitely determined and the taxes paid. (I. T. 2902 (C. B. XIV-2, 67 (1935)) held that New York City sales taxes are deductible as such only by the vendee.)

Advice is requested as to the deductibility, for Federal income tax purposes, of certain additional New York City sales taxes for 1935, 1936, and 1937, assessed against the M Company in 1939 and paid by it in that year. The circumstances are set forth below.

The greater portion of the additional taxes was due to the fact that the M Company had not added any sales tax on material installed under lump-sum contracts. It considered the installations as being affixed to realty and the sales not subject to tax because made for the improvement of real property. The tax authorities ruled otherwise and in 1939 the company was assessed accordingly. Also, a small

portion of the additional assessment covered taxes on sales of material shipped from without the State into New York City which the company considered interstate commerce and the sales not subject to the tax. The tax authorities also ruled that such sales were taxable and that ruling has since been upheld by the United States Supreme Court.

The Bureau held in I. T. 2902 (C. B. XIV-2, 67 (1935)) that New York City sales taxes are deductible by the purchaser or vendee for Federal income tax purposes. Although the vendor is liable for collection and payment of the sales taxes, it is liable only as collecting agent for New York City and such liability, even if accrued on the vendor's books at the time of sale, would not have been an allowable deduction for Federal income tax purposes.

Inasmuch as the additional sales taxes were assessed against the M Company in 1939 and that company was required in that year to pay out of its own funds the amounts which it should have collected from its vendees in earlier years, it is held that, while the additional payment of tax for the respective years is an allowable deduction in determining net income for 1939, it is deductible not as a tax but as a business expense under section 23(a) of the Internal Revenue Code.

SECTION 19.23(c)-1: Taxes. 1941-13-10658
I. T. 3460

INTERNAL REVENUE CODE.

The accrual date for Federal income tax purposes of the Michigan intangible personal property tax is December 31 of the calendar year 1940 and subsequent years for those taxpayers on a calendar year basis or, for those taxpayers who report on a fiscal year basis in lieu of the calendar year, the last day of such fiscal year.

Advice is requested as to the date of accrual of the Michigan intangible personal property tax for Federal income tax purposes.

The tax in question was imposed under the provisions of Act No. 301, Public Acts of 1939, effective September 29, 1939, which is restated as section 7.556 in volume 6 of the Michigan Statutes Annotated. Section 7.556(1) relates to definitions and subparagraphs (b) and (e) read as follows:

(b) The term "intangible personal property" means accounts receivable, moneys on hand or on deposit or in transit, interest bearing obligations for the payment of money, including bonds, certificates of indebtedness, debentures, notes, and certificates of deposit, either secured or unsecured, annuities, royalties, shares of stock in corporations, associations, and joint stock companies, certificates of ownership in enterprises conducted for profit (not, however, including partnership agreements), equitable interests in any of the foregoing classes of intangible property, and any and all other credits and evidences of indebtedness.

* * * * * * *

(e) The term "tax year" or "taxable year" means the calendar year, or the taxpayer's fiscal year when permission is obtained by him from the commission to use his fiscal year as the tax period in lieu thereof.

Other provisions of the law pertinent to the question are as follows:

SEC. 7.556(2). *Tax on ownership of intangible personal property; rate, income producing property, non-income producing property; computation of value; reduction of tax.*]

SEC. 2. For the calendar year 1940, and for each year thereafter there is hereby levied upon each owner of intangible personal property not hereinafter exempted having a situs within this State, and there shall be collected from such owner an annual specific tax on each item of such property owned by him. The tax on income producing intangible personal property shall be 6 per cent of the income but in no event less than one-tenth of 1 per cent, nor more than three-tenths of per cent of the face or par value of each item (or in the case of corporate stock or other evidence of corporate ownership having no par or face value, of the average per share contribution to capital, surplus and other funds in consideration of which all of the then outstanding shares of stock of the same class of such corporation shall have been issued). The tax on non-income producing intangible personal property shall be one-tenth of 1 per cent of said face, par or contributed value. The value, for the purpose of this section, of any item of property the value of which changes during the year shall be the average value to be computed under such rules and regulations as the commission may adopt. If any item of intangible personal property subject to tax under this subsection is owned by the taxpayer for only a portion of the calendar year the tax levied hereunder shall be reduced in proportion.

Intangible personal property subject to tax under this act shall be exempt from all general property taxes under the laws of this State.

* * * * * * *

SEC. 7.556(4). *Annual return; payment of tax, extension of time.*]

SEC. 4. On or before 60 days after the end of the tax year each person owning intangible personal property subject to tax under this act shall make a return in form and content as prescribed by the commission, showing the personal property subject to taxation hereunder for the preceding tax year and showing the face, par, or contribution value of each item of such property. * * *

In view of the fact that the intangible personal property tax imposed by the State of Michigan for the calendar year 1940 and subsequent years is measured by factors or conditions relative to ownership which may exist, cease, or arise at any time within the period of the tax year, it is held that the accrual date of the Michigan intangible personal property tax is December 31 of the calendar year 1940 and subsequent years for those taxpayers on a calendar year basis, or, for those taxpayers who report on a fiscal year basis in lieu of the calendar year, the last day of such fiscal year.

SECTION 19.23(c)-1: Taxes.

INTERNAL REVENUE CODE.

Michigan corporation franchise fees. (See I. T. 3468, page 231.)

SECTION 19.23(c)-2: Federal duties and excise taxes. 1941-4-10575 G. C. M. 22366

INTERNAL REVENUE CODE.

Adjustment to reflect the increase, by reason of section 205 of the Revenue Act of 1940, in the capital stock tax deduction accruing, for Federal income tax purposes, on July 1, 1939, should be required with respect to taxable years ended on April 30, 1940, or May 31, 1940. With respect to taxable years ended on March 31, 1940, or prior thereto, it can not be said that the Revenue Act of 1940, approved June 25, 1940, was passed in ample time to make the adjustment, for which reason the increase in the allowable deduction may be taken in the succeeding taxable year.

An opinion is requested as to the application of G. C. M. 17340 (C. B. XV-2, 81 (1936)) to the accrual, for Federal income tax purposes, of the deduction for capital stock tax for income-tax taxable years ending in 1940.

In G. C. M. 17340, supra, it was held (syllabus):

The accrual date for capital stock taxes for each of the years ending June 30, 1935, June 30, 1936, and June 30, 1937, is the beginning of such capital stock tax year (that is, July 1, 1934, July 1, 1935, and July 1, 1936, respectively), if the corporation was engaged in business on those dates.

It was stated in that ruling that "where the taxing policy of a State or government is continuous, a new law which merely increases the rate of taxation and which is retroactive in effect should not be used as a basis for shifting the otherwise recognized accrual date."

The present question has arisen by reason of the increased capital stock tax imposed by section 205 of the Revenue Act of 1940, approved June 25, 1940, for the capital stock tax year which began on July 1, 1939, and ended on June 30, 1940, the capital stock tax for such year having accrued on July 1, 1939, for Federal income tax purposes. The question is whether, for taxable years ended before the passage of the Revenue Act of 1940 imposing the additional tax, G. C. M. 17340, supra, must be strictly applied and adjustment made in income tax returns which have already been filed in order to reflect the increased capital stock tax deduction, or whether the increase in such deduction may be taken in the succeeding taxable year in accordance with the principle recognized in I. T. 2827 (C. B. XIII-2, 130 (1934)). In I. T. 2827 it was held that in the case of a corporation which files its income tax return on the calendar year basis the capital stock tax imposed by section 215 of the National Industrial Recovery Act for the period ended June 30, 1934, which accrued July 1, 1933, should be claimed as a deduction in the calendar year 1933 and should be included in gross income for the calendar year 1934, the Revenue Act of 1934 having amended the National Industrial Recovery Act by providing that the capital stock tax imposed by the latter should not apply to any taxpayer in respect of any year except the year ended June 30, 1933.

In the opinion of the Supreme Court of the United States in *Fawcus Machine Co.* v. *United States* (282 U. S., 375, Ct. D. 278, C. B. X-1, 424 (1931)), cited in G. C. M. 17340, supra, the following statement is made:

* * * The Act was passed in ample time to allow the taxpayer to readjust its accounts for that year by including these taxes * * *.

It is the opinion of this office that G. C. M. 17340, supra, should be applied so as to require adjustment only in those returns which are due subsequent to the date of enactment of the amending legislation, for only in such cases may it be said that the legislation was passed in ample time to allow taxpayers to readjust their accounts. The Revenue Act of 1940 was approved on June 25, 1940. Accordingly, those taxpayers who filed their returns on a fiscal year basis ended April 30, 1940, or May 31, 1940, should be required to adjust the July 1, 1939, accrual of capital stock taxes. With respect to taxable years

ended on March 31, 1940, or prior thereto, it can not be said that the Revenue Act of 1940 was passed in ample time to permit an adjustment.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

SECTION 23(e).—DEDUCTIONS FROM GROSS INCOME: LOSSES BY INDIVIDUALS.

SECTION 19.23(e)–1: Losses by individuals. 1941–3–10565
I. T. 3442

INTERNAL REVENUE CODE.

G. C. M. 21503 (C. B. 1939–2, 205), in which it was held that where a contract to sell stock on a stock exchange for less than the basis thereof was entered into on the last day of a taxable year and delivery of the stock was made in the regular way on January 2 of the following year, the loss on the transaction was incurred in the earlier year and constitutes a proper deduction for that year, is also applicable to stock exchange sales of bearer bonds on which interest is computed to date of delivery.

Advice is requested whether G. C. M. 21503 (C. B. 1939–2, 205) is applicable to the sale of bearer bonds as well as to the sale of stock. It is stated that the inquiry arises by reason of the fact that where bearer bonds are sold on a stock exchange interest is computed to the date of delivery, which, according to stock exchange rules, is two days after the date of sale.

In G. C. M. 21503, supra, it was held that where a contract to sell stock on a stock exchange for less than the basis thereof was entered into on December 31, 1930, and delivery of the stock was made in the regular way on January 2, 1931, the loss on the transaction was incurred in the year 1930 and constitutes a proper deduction for that year.

It is held that the rule laid down in G. C. M. 21503, supra, with respect to a sale of stock applies equally to a similar transaction involving a sale of bearer bonds on which interest is computed to the date of delivery. The loss is deductible for Federal income tax purposes for the year in which the transaction was consummated except for delivery of the bonds.

SECTION 19.23(e)–1: Losses by individuals. 1941–23–10730
(Also Section 23(g), Section 19.23(g)–1.) I. T. 3479

INTERNAL REVENUE CODE AND REVENUE ACT OF 1938.

Losses sustained by a taxpayer, who keeps his books on the cash receipts and disbursements basis, with respect to payments required to be made in 1938 and 1939 on stock purchased in 1932 on the deferred payment plan, which stock became worthless in 1935, are not subject to the limitation provisions of section 23(g)2 of the Revenue Act of 1938 and the Internal Revenue Code, relating to capital losses.

Advice is requested relative to the deductibility for Federal income tax purposes of losses sustained by A, who files his returns on the basis of cash receipts and disbursements, on account of deferred pay-

ments for stock in the years 1938 and 1939, which stock was purchased in 1932 and became worthless in 1935.

In 1932 A subscribed for certain shares of stock of the M Corporation and signed a contract obligating himself to pay $5x$ dollars over a period of years. The corporation was dissolved by order of court in 1935, at which time it was definitely determined that the stockholders would receive nothing in final liquidation. Although the stock became worthless in 1935, A continued to make partial payments during the years 1935 to 1939, inclusive, in discharge of his liability under the stock purchase agreement.

The question presented is whether the payments made in the years 1938 and 1939 are losses to which section 23(e) of the Revenue Act of 1938 and the Internal Revenue Code applies, or whether such losses are within the purview of section 23(g)2 of the Revenue Act of 1938 and the Internal Revenue Code, which provides as follows:

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.

In accordance with the ruling published as I. T. 3252 (C. B. 1939–1 (Part 1), 182), the losses sustained by A, who files his returns on the cash receipts and disbursements basis, are deductible in the year or years in which payments are made on the contractual obligation. Inasmuch as the stock in the instant case became worthless in the year 1935 and not during the "taxable year" (1938 and 1939) it is held that the losses, represented by partial payments in 1938 and 1939, are not subject to the limitation provisions of section 23(g)2 of the Revenue Act of 1938 and the Internal Revenue Code, relating to capital losses, but are ordinary losses deductible in their entirety under the provisions of section 23(e) of the Revenue Act of 1938 and the Internal Revenue Code for the years 1938 and 1939, respectively.

SECTION 23(g).—DEDUCTIONS FROM GROSS INCOME: CAPITAL LOSSES.

SECTION 19.23(g)-1: Capital losses.

INTERNAL REVENUE CODE.

Losses on account of payments for stock after stock becomes worthless. (See I. T. 3479, page 212.)

SECTION 23(l).—DEDUCTIONS FROM GROSS INCOME: DEPRECIATION.

SECTION 19.23(l)-1: Depreciation.

INTERNAL REVENUE CODE.

Teachers' libraries. (See I. T. 3448, page 206.)

SECTION 23(m).—DEDUCTIONS FROM GROSS INCOME: DEPLETION.

SECTION 19.23(m)-1: Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements. 1941-26-10755 G. C. M. 22730

INTERNAL REVENUE CODE AND PRIOR REVENUE LAWS.

Status of oil and gas leasing transactions for Federal income tax purposes, including review of controlling cases and discussion of issues relating to acquisition and assignment of interests in oil and mineral properties, the division of income derived from the sale of the product among the parties entitled to share therein, and the depletion allowances granted such parties.

An opinion is requested with respect to the status of oil and gas leasing transactions for Federal income tax purposes, the acquisition and assignment of interests in oil and mineral properties, the division of income derived from the sale of the product among the parties entitled to share therein, and the depletion allowances granted such parties.

The following suppositious case presenting the questions involved may be stated for convenient consideration. A, as a fee owner of oil lands, leased the lands to B in consideration of a cash payment of $100,000, an additional $100,000 payable out of one-sixteenth of the oil and gas if, as, and when produced, and a one-eighth royalty interest. B then assigned his leasehold interest to C in consideration of a cash payment of $200,000, and an additional $100,000, payable only out of one-sixteenth of the oil and gas if, as, and when produced. C assigned one-half of the lessee interest to D, who agreed to develop and operate the property, to advance C's share of the funds necessary for development costs and operating expenses, to sell all the oil produced and saved and credit C with one-half of the proceeds until all advances were fully recouped, and thereafter to operate the property and pay one-half of the proceeds from the sale of all oil produced, less one-half of the operating expenses, to C, who was not personally liable for any costs or expenses incurred or advances made. E drilled an oil well under an agreement with D entitling E to have delivered to his credit one-eighth of all the first oil and/or gas if, as, and only when the same is produced, saved, and marketed from the land until he received the sum of $25,000. Also, F paid D the sum of $15,000, which D covenanted to use in developing the property, and D agreed to pay F the sum of $25,000, payable out of one-eighth of the oil and/or gas if, as, and only when the same is produced, saved, and marketed from the leased land.

In *Lynch* v. *Alworth-Stephens Co.* (267 U. S., 364, T. D. 3690, C. B. IV-1, 162 (1925)) and cases therein cited, the United States Supreme Court, though it expressly recognized the hardship involved in treating all proceeds from the extraction and sale of ore as ordinary income in view of the fact that mining operations reduce the value of property interests in mineral deposits, made it clear that such reduction in value is not depreciation but depletion, and that the capital investments in minerals of both the lessor and the lessee are returnable to them tax-free only through depletion deductions expressly granted by statute. (See also *Helvering* v. *Mountain Producers Corporation*, 303 U. S., 376,

Ct. D. 1321, C. B. 1938–1, 343, wherein the Court stated that the depletion allowance rests upon legislative grace.)

Though the Revenue Act of 1916 did not expressly provide for the allocation of depletion between the parties in interest, the Court in the Alworth-Stephens case regarded both the lessor and the lessee of mining property as owning valuable property rights in the mineral in place which were reduced in value through the extraction of ore, and it held the total depletion allowable was allocable between the lessor and the lessee in proportion to the interests of each severally considered.

Subsequent decisions hold that the incidental exhaustion of natural deposits through the production and sale of oil or minerals is not a sale or conversion of capital assets allowing cost or basic value to be recovered tax-free. Further, a sale of capital assets is not involved in a lease agreement in which the lessor, in consideration of a bonus or lump sum cash payment made at the time the lease was executed (hereinafter referred to as a "bonus") and stipulated royalties measured either by a percentage of production under the lease or by a stated sum per unit extracted and sold (hereinafter referred to as "royalties") which are payable over the entire lease life, grants a lessee the right to enter upon and use the land for purposes of exploitation. (See *Bankers Pocahontas Coal Co.* v. *Burnet*, 287 U. S., 308, Ct. D. 618, C. B. XII–1, 272 (1933), and *Burnet* v. *Harmel*, 287 U. S., 103, Ct. D. 611, C. B. XI–2, 210 (1932), involving ordinary royalties paid a lessor of coal lands on the basis of a fixed amount per ton mined, and a bonus paid the lessor of oil lands, respectively.) The Court thus not only recognized that royalty payments like rental payments are ordinary income to the lessor, but drew an analogy between cash bonus payments made upon the execution of an oil and gas or mining lease and a substantial payment received in the first year by a lessor in any other type of lease for purposes of classifying such bonus payments as ordinary income rather than proceeds from the sale of capital assets.

Such classification of bonus payments does not depend upon whether the local law regards the agreement between lessor and lessee as a lease or a sale of natural resources in place. In *Palmer* v. *Bender* (287 U. S., 551, Ct. D. 641, C. B. XII–1, 235 (1933)) the Court refused to distinguish between lessors and sublessors or assignors of leasehold interests who, by stipulation for royalty payments, reserve an interest in production coextensive with the leasehold life. The taxpayer therein was a member of several partnerships, each of which had acquired an oil lease, had discovered oil, and had then assigned the lease to a third party in consideration of a bonus payment, a future payment of a stated sum to be made out of one-half of the first oil produced and saved (which type of payment will hereinafter be referred to as an "oil payment"), an interest which does not by its terms extend throughout the lease life, and an additional "excess royalty" of one-eighth of all of the oil produced and saved. The Court held that the bonus payment, the oil payments, and the royalty payments were ordinary income to the sublessor or assignor subject to the depletion allowance, rather than proceeds from the sale of capital assets. The Court refused to distinguish between leases governed by varying State laws which apply different rules as to when technical title to oil and gas passes to the lessee, on the ground that the economic consequences to the lessor are the same in all cases—i. e.,

the value of his interest is lessened by the extraction of oil. The Court stressed the general view that all persons having a right to share in the oil produced or the proceeds from its sale, irrespective of the legal form of their interest in the property, have an economic interest in the oil and gas in place to which the depletion provisions are applicable, the language of the statute, providing that the depletion allowance shall be allocated between lessor and lessee, being held to be broad enough to provide, at least, for every case in which the taxpayer has acquired by investment any interest in the oil in place, or has secured, by any form of legal relation, income derived from the extraction of oil to which he must look for a return of his capital. The opinion states that a lessor, or sublessor or assignor, who stipulated for the payment of future royalties in kind from the oil produced and saved, had retained an economic interest in the oil and gas in place entitling him to depletion deductions against cash bonus payments as well as proceeds from his share of the oil. The opinion implies that the proceeds from the sale of any share in the oil produced are income subject to depletion in the hands of the one entitled to such share. Further, the Court speaks of the oil and gas in place as a reservoir of the capital investments of the several parties entitled by agreement to share in the oil and gas produced under the lease.

Such language indicates that the Court regarded the contracts between the interested parties as dividing the property rights in oil and gas in place in accordance with their respective shares upon production. That is, the lessor, by lease terms reserving royalties, merely grants to the lessee exclusive exploitation privileges, retaining as his share of the oil and gas in place that portion thereof which, freed of the burdens of development and operating costs, has a value equivalent to the value of the entire interest subject to such burdens, and, therefore, like the lessor of an ordinary lease reserving rent, is regarded as not having disposed of a capital asset. The remaining fractional interest in oil and gas in place becomes the share of the lessee's working or operating interest which carries the risks and burdens attending exploitation. If the lessee in turn subleases or assigns the working interest, reserving a royalty share, he acquires a status comparable to that of a lessor with respect to the share retained, any further burden of exploitation being passed on to the sublessee or assignee with an agreed share in the oil and gas produced. So considered, the view that a lessor, or a sublessor or assignor, parts with no capital interest, though the lessee, or sublessee or assignee, acquires a capital interest upon the execution or assignment of a lease, presents no logical difficulties, as the lessee interest, though it may have great potential value, ordinarily becomes valuable only upon investment by the lessee in exploitation or by reason of discovery. Under this theory, the lessee does not pay rent to the lessor by royalty payments but, instead, divides the product or the proceeds realized therefrom with him. Thus, in the classification of royalty payments as "rent" to the lessor, the term is employed as denoting a sharing by the lessor for the use of his land rather than as an amount owing and paid by the lessee. A cash bonus, though termed an advance royalty payment, paid to a lessor without regard to production and often in a year when there is no production, is not a

division of products or proceeds therefrom. Nor, as already noted, does it represent proceeds from the sale of a capital asset to a lessor reserving a royalty interest. The lessor does not sell an interest to the lessee. Instead, the lessee acquires an interest by assuming the obligation to develop and operate the property.

The analogy between the bonus payment accompanying a mineral lease and a large payment made in the first year of any ordinary lease, to which the Court resorted to characterize the bonus payment as ordinary income as distinguished from capital gain to the lessor, does not establish an identity of character in the two types of payments for Federal income tax purposes. An oil or mineral lease differs from an ordinary land lease in that it contemplates severance and disposition of valuable mineral deposits that normally represent a large percentage of land values. Further, the allowance of depletion deductions to the lessor, which serve to offset his bonus income and reduce the basis of his interest, establishes the distinction between such payments by treating the bonus payment upon an oil or mineral lease as, in part, a tax-free return of the lessor's capital investment in mineral in place. As the mineral in place is a reservoir of the capital investments of the parties returnable through the depletion allowance, and as the bonus payment results in a reduction in the lessor's capital investment to the extent of the depletion allowable thereon, it follows that such payment is a contribution by the lessee to such reservoir of capital investments which is substituted for the capital thereby withdrawn by the lessor. Such shifting of capital investment is attended by a corresponding shift in the value of the respective capital interests or share rights of the parties. That is, a bonus payment diminishes the value of the lessor's mineral interest by reducing his royalty share in future production. The depletion allowance on his bonus income is designed to compensate him for such diminution in value of his interest thereby sustained. Correspondingly, the bonus payment enhances the value of the lessee's interest by giving him a larger share of the minerals produced, or the proceeds therefrom, by reason of his bonus investment.

It will be noted that the analogy between a bonus payment made upon the execution of an oil or mineral lease and a large rental payment made in the first year of any ordinary lease, upon which the Supreme Court based its conclusion that such bonus payment was ordinary income in the nature of an advance royalty payment subject to the depletion allowance rather than proceeds from the sale of a capital asset, is not available to permit of like treatment of a cash payment made where no royalty right is reserved by the payee. Royalty rights represent a share in all of the oil or mineral in place, and a bonus payment which reduces the royalty and, therefore, the lessor's capital interest in every unit of oil or mineral content may properly be termed an advance royalty. Unlike ordinary rights to rent or royalty, oil payment rights represent share rights in only a portion of the oil or mineral content of the land. When the stipulated payments are made, the payee's interest in oil or mineral expires. A cash payment made upon the execution of an instrument stipulating only for oil payments is, therefore, regarded not as an advance royalty payment but as proceeds from

a sale in which the payee disposed of his economic interest in oil or mineral in place, less the fraction thereof represented by the oil payment rights reserved by him. (See *Commissioner* v. *Fleming*, 82 Fed. (2d), 324.)

It thus appears that (1) agreements to pay royalties measured by a fraction of the mineral product or the proceeds therefrom, or by a stated sum per unit extracted and sold, in effect divide the proceeds from production, and (2) cash bonus payments representing advance royalty payments effect a substitution in the reservoir of capital investments of lessee invested capital for invested capital withdrawn by the lessor in the amount of depletion sustained by him, thereby giving the lessee a larger share upon production and, consequently, a greater interest in natural deposits in place than he would have had if there had been no cash bonus payment. A cash payment representing proceeds from the sale of an economic interest also accomplishes a substitution of payor invested capital for payee invested capital. The payee in such a case realizes capital gain or loss measured by the difference between cost allocable to the interest sold and the proceeds received.

The stated basic concepts of income and the attending depletion allowances apply to depletion provisions basing allowances on percentages of gross income from the properties as well as to the provisions of the earlier Acts granting allowances based upon cost or value at March 1, 1913, or upon discovery value. In *United States* v. *Dakota-Montana Oil Co.* (288 U. S., 459, Ct. D. 655, C. B. XII–1, 243 (1933)), treating capitalized intangible costs of development as returnable through the depletion allowance, the Court pointed out that there is "no ground for supposing that Congress, by providing a new method for computing the allowance for depletion intended to break with the past and narrow the function of that allowance." The Court said that the "reasonable inference is that it did not and that depletion includes under the 1926 Act precisely what it included under the earlier Acts." In *Herring* v. *Commissioner* (293 U. S., 322, Ct. D. 904, C. B. XIV–1, 303 (1935)) the Court stated that the nature and purpose of the allowance based on a percentage of income are the same as in the case of the allowance based on cost, and allowed a lessor receiving an advance royalty or bonus payment upon the execution of an oil and gas lease a percentage depletion allowance thereon. The fact that such an allowance is in anticipation of production was stated to be no more persuasive under the percentage depletion provisions than it was under the depletion provisions of the earlier Acts.

Aside from such bonus payment to a lessor or assignor, the term "gross income," as used in the phrase "gross income from the property" in the percentage depletion provisions, means the same as "gross income" in the provisions generally defining income, with the qualification that the phrase "gross income from the property" in the depletion provisions is confined to the gross income from the extraction of oil rather than gross income from the tract of land in all its uses. (See *Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S., 312, Ct. D. 905, C. B. XIV–1, 253 (1935), involving an assignee of an oil and gas lease which was obligated to pay royalties in cash or in kind totaling one-fourth of the oil extracted.) The taxpayer-assignee in

Helvering v. *Twin Bell Oil Syndicate*, supra, contended that the entire gross income from production of oil and gas was its gross income from the property and claimed the deduction of 27½ per cent thereof as its allowance for depletion. The Court held that the income from production and sale of the products and the depletion allowance thereon, however measured, must be apportioned between lessor and lessee. Thus the Court confirmed the implications of the earlier cases involving lessors and sublessors or assignors by applying the basic concepts as to (1) gross income from production, and (2) depletion allowances and their division between the respective parties interested.

In the last-cited case the Court, in effect, pointed out that an agreement to pay royalties represents a sharing arrangement between the parties by expressing the view that the provision of a later Act, section 114(b)3, Revenue Act of 1932, which expressly excludes royalties paid or incurred in respect to the property from the lessee's gross income from the property, was merely declaratory of existing law. This implication as to division between the parties by means of royalty payments was confirmed and extended to include divisions effected by agreements to make oil payments in *Thomas* v. *J. J. Perkins et al.* (301 U. S., 655, Ct. D. 1237, C. B. 1937–1, 162), wherein proceeds from the share of oil reserved by an assignor were held not to be income to the assignee. In that case, lessees of oil and gas leases assigned the leases for $395,000, payable out of one-fourth of the oil produced free of any share of development expense or any other burden. The Palmer case, supra, was cited as supporting the view that the oil payment interest retained by the assignors gave them ownership of the stipulated share of the oil and entitled them to the income therefrom and the depletion allowance thereon. The Twin Bell Oil case, supra, was cited as holding that it is immaterial whether the lessor, or sublessor or assignor, is to receive the royalty in oil or the proceeds from the sale of his share of such oil by the lessee.

The cited cases show that the stated basic principles apply equally to mineral deposits and to oil and gas. Like issues arise in the oil and mineral cases which are cited interchangeably in the evolution of the applicable rules. The parties entitled to share in oil or mineral extracted, or the gross proceeds therefrom (including the parties to a lease providing for royalty payments of stated amounts per unit mined), have economic interests in the oil or minerals in place. That is, they, as owners of the rights in oil or other mineral in place, share the income from production, and the depletion allowances thereon are regarded as designed to permit tax-free recovery of at least their capital investments in such property rights. (See also the Mountain Producers case, supra, wherein the royalty payable by the producer was measured by a per unit price based on current gasoline prices.)

It will be noted that the persons entitled to oil payments or royalty payments, which the above-cited cases have characterized as the owners of economic interests in oil or mineral in place, by the terms of the agreements from which these rights arise, are assured of a share if there is production of oil or mineral. *J. Steve Anderson et al.* v. *Helvering* (310 U. S., 404, Ct. D. 1456, C. B. 1940–1, 108) con-

firms this view. The obligation there involved was not an ordinary oil payment right, as it was payable out of proceeds from oil produced or proceeds from resale of the properties. Payment out of proceeds from resale would liquidate the obligation and terminate the right to share in production income.

Assurance of a share upon production marks ownership of an economic interest in oil and gas in place. Division of production income and the attending depletion allowances between owners of economic interests necessarily exclude all others. The right to share in production or gross income therefrom should not be confused with a contractual right to purchase and process a product of the mine or well, even though such processing incidentally aids production and is done under a sharing of the processed product with the producers. In *Helvering* v. *Bankline Oil Co.* (303 U. S., 362, Ct. D. 1323, C. B. 1938–1, 306) the taxpayer contracted with producers of oil and gas for the treatment of wet gas to produce gasoline. The taxpayer agreed to install and maintain necessary pipe lines and connections from casingheads or traps at the mouth of the well to its plant, and the producers agreed to deliver the natural gas from which the taxpayer was to extract the gasoline and return part of the dry gas to the well to be used therein for pressure purposes. The taxpayer agreed to deliver one-third of the gasoline extracted or the gross proceeds from the sale of such share. The Court held that the taxpayer was a mere purchaser of the gas produced from the well and not a producer of gas having a depletable economic interest in mineral in place. It should be noted that the taxpayer's capital investment was in equipment facilitating delivery of the gas produced rather than in equipment for production of gas, and that its function was not production of gas but the processing of gas. The Mountain Producers case, supra, is distinguishable in that the refining company purchaser therein was a producer and was required to make the capital investments necessary to production that gave the producer an economic interest in oil and gas in place.

Similarly, a right to share in production, or the gross income therefrom, is very different from the right to share in the net income of the producer (a right measured not by production of mineral, as such, but by the degree of success in operation of such a right owned by another). (See *Helvering* v. *Elbe Oil Land Development Co.*, 303 U. S., 372, Ct. D. 1322, C. B. 1938–1, 293, as interpreted by the Anderson case, supra, and *Helvering* v. *O'Donnell*, 303 U. S., 370, Ct. D. 1324, C. B. 1938–1, 337.) In the Elbe case, supra, the rights in oil properties and equipment were transferred for a stated consideration payable in annual installments, irrespective of production from the properties transferred, plus one-third of the net profits derived from operation of the properties by the purchaser after it had been reimbursed from oil and gas proceeds for all expenditures made by it in the acquisition, development, and operation of the properties. The interest of the seller was thus limited to a right to share in net income after recoupment of capital expenditures rather than gross proceeds from production. In the O'Donnell case, supra, stock of a corporation owning oil property rights was sold to another corporation (which was to take over in liquidation the oil properties of the first corporation and operate them) for a one-third share of the net profits derived from the operation of

the oil properties. In both cases, the Court held the transfers to be sales, and that in neither case did the transferor have a depletable economic interest in the mineral in place after the transaction had been completed.

It seems clear that the right to share in production, or the gross proceeds therefrom, which distinguishes ownership of depletable economic interests in oil or mineral in place from nondepletable economic advantages, including contractual rights to purchase the product or to share in net income, does not depend upon legal title to the oil and gas or mineral deposits. (*Burnet* v. *Harmel*, supra, and *Palmer* v. *Bender*, supra.) Also, as noted above, in the Palmer case, technical legal description or characterization of the right was treated as immaterial, the Court saying that the owner of a depletable economic interest includes any taxpayer who "has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital." In the Anderson case, supra, the Court in discussing the Perkins case, supra, involving an oil payment right reserved upon assignment, said the "decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments of that type."

Such language seems as applicable to grants as to reservations of economic interests, as the formalities of the conveyancer's art are quite as exacting in the reservation of interests as in the grant of interests. If, as the Court indicates, the mere stipulation for oil payments to a person having an investment or capital interest in oil properties amounts, in effect, to a retention of a depletable economic interest in oil in place to the extent of such oil payments, then it would seem to follow that an agreement entitling one making an investment (thereby acquiring a capital interest) in such properties to such payments would give him a corresponding depletable economic interest therein. The point assumes importance in view of the many contracts entered into by owners of lessee interests with well drillers to drill wells, equipment dealers to furnish equipment, and investors to furnish money for use in developing the leased property in return for agreements to make stated payments out of a share of the oil. By such arrangements, a lessee commonly lessens his own investment and the risks and burdens attending development by agreements to share the investment obligation and the proceeds of production. The lessee or assignee, like the lessor or assignor who retained a share interest in production having a value equivalent to that of the lessor's prior interest but passed on to the lessee the investment obligations and risks that attend development for a share in production, has parted with no capital interest but has merely in turn given another a right to share in production in consideration of an investment made by such other person. If the driller or equipment dealer is making an investment by which he acquires an economic interest in oil and gas in place, expenditures made by him represent capital expenditures returnable tax-free through the depletion allowance rather than by way of expense deduction, and the oil payment rights acquired do not represent payment in property

for services rendered or supplies furnished. Similarly, one who, in return for an oil payment right, furnishes money which the lessee is pledged to use in developing the property would be regarded as making an investment representing an addition to the reservoir of capital investments in oil and gas in place (as distinguished from the purchase of an oil payment right from the lessee wherein there is no such pledge to invest the proceeds in development and the buyer's capital investment would replace the lessee's capital investment allocable to the interest sold). Such a transaction, involving a pledge to use the money furnished in developing the property, is distinguishable from a sale the proceeds of which are unqualifiedly received by the seller. This view seems to accord with the realities of such transactions. In none of such cases has the lessee parted with a capital asset, and the investments involved are not his investments.

The stated principles seem applicable irrespective of whether there are words purporting to convey an interest in the oil in place involved in the oil payment rights. Both the practical and economic consequences of provisions for payments of this type are identical in either case. It seems generally agreed that, irrespective of conveyancing formalities, a right to a share of the oil produced carries with it a corresponding interest in the oil in place. That rights to share in the oil produced are analogous to rights to share in gross proceeds derived from the sale of oil produced has been repeatedly stated by the highest Court. It would seem to follow that a right to a share of the proceeds from the sale of oil produced would give the payee ownership of a corresponding depletable economic interest without regard to conveyancing formalities.

It thus appears that the controlling cases regard capitalized development costs as representing investments returnable through the depletion allowances, whether the total development investment is made by a landowner who elects to develop the property himself and take all the oil or mineral or is shared by a number of investors who, by contractual arrangements between themselves, agree to divide the resulting oil or mineral product or the proceeds from the sale of such product. If the latter, the division of oil, or the gross income therefrom, determines the economic ownership of oil or mineral in place as well as the gross income and attending depletion allowances. Under this test, the form of the contracts dividing the product or the gross income therefrom, or the legal phraseology or devices utilized to accomplish the division, are immaterial. For example, an instrument purporting to be a "lease" of oil or mineral lands, which gave a "lessee" a right to explore for and produce all the oil or mineral found thereon and required the "lessee" to pay the "lessor" only a share of the net profits derived from the operation (as distinguished from a share of the product or the proceeds from the sale of the product), would leave the "lessor" without a depletable economic interest in the oil or mineral in place, and a "bonus" payment, if any, made upon the execution of such instrument would represent proceeds from the sale of a capital asset. Such results accord with the realities of the test supplied. Under such an agreement, the lessee may exhaust a substantial oil or mineral content with little or no realization of net profits, in which event

the lessor will receive little or nothing under the contract. That being true, the lessor in effect has not retained an interest in the oil or mineral content.

Similarly, the Federal income tax status of a "carried interest" depends upon the extent to which such interest in effect represents a right to share in gross income as distinguished from net income derived from the operation. In *Reynolds* v. *McMurray* (60 Fed. (2d), 843, certiorari denied 287 U. S., 664, Ct. D. 616, C. B. XII–1, 198 (1933)), McMurray was the owner of an undivided interest in oil leases, subject to a contract with the Ohio Oil Co., which also owned an undivided interest in such leases. Under the contract, the parties agreed that the Ohio Oil Co. was to manage, control, develop, and operate such leases and pay all costs incident thereto and charge McMurray's undivided interest with its proportionate part thereof; that it should market the oil and gas produced and account to McMurray for his proportionate part thereof; that it should be reimbursed by McMurray from the proceeds derived from the sale of his proportionate part of the oil and gas, to be effected by crediting McMurray's account with the Ohio Oil Co., on the 1st of each month, with the proceeds derived from the sales during the month preceding of his proportionate part of the oil and gas; and that it should make monthly remittances to him of his proportionate share of any proceeds remaining after deducting the amounts due it for expenditures made by it for him.

The economic or practical effect of such contract was to turn over the leasehold estate to the Ohio Oil Co. for development and the extraction and sale of the product. Though McMurray retained legal title to his undivided interest under the lease, he contracted away the only right granted thereby—i. e., to extract and sell the oil content of the leased land. Thereafter, the development and operation of the property were carried on by the oil company on its own behalf and not as a joint operation by co-owners. Proceeds from the sale of oil were not divided between the parties. Charges and credits in the account between the parties did not reflect actual obligations between them. Rather, they were merely factors in computing the net income payments which were all McMurray could ever become entitled to under the agreement, regardless of how much oil was extracted and sold from the leased premises. McMurray's interest was converted into a mere contractual right to share in any net income derived from the sale after recoupment of all capital invested by the oil company. The oil company was obligated to make all of the investment necessary to develop the property and to pay all the costs of operation, and it could look only to the proceeds from the sale of the lessee share of oil and gas produced for reimbursement of its capital expenditures and operating expenses. The oil company assumed all the risks and burdens attending development and operation, and it was entitled under the contract to the entire lessee share of production which was the only source from which its capital and expenses could be recouped. Accordingly, such investment was in an economic interest in oil and gas in place measured by the lessee share of production. It is, therefore, the opinion of this office that the decision in that case, holding that the

proportionate share of the proceeds from the sale of oil ostensibly credited to McMurray was constructive income to him, is out of harmony with the above-described test of ownership of income from production, and it should no longer be followed. In cases where, after recoupment of such charges or so-called advances to the "carried interest," the interest ceases to be a "carried interest" and the owner thereof becomes entitled to a share in the oil, or the gross income therefrom, and liable for his share of costs and expenses, he should be regarded as retaining under the contract an economic interest in oil in place, consisting of his undivided interest in the lease less the right of recoupment, which is comparable to an oil payment right, carved out of his fractional working interest.

The questions presented by the supposititious case stated herein are answered generally by the above discussion. Specifically, A, the fee owner, realized $100,000 bonus income when the lease was executed. He also realizes as income one-sixteenth of the proceeds from production until that fraction produces $100,000, and one-eighth of such production as royalty income so long as production continues. All of such income is ordinary income. He is entitled to corresponding depletion allowances, and suffers reductions in the bases of his oil payment and royalty interests resulting from such depletion deductions. A lessee who subleased or assigned his interest for like consideration would occupy a comparable position. The $200,000 which C paid to B was consideration for the sale of B's interest, less the retained oil payment of one-sixteenth interest until $100,000 is produced. B is not entitled to depletion on the $200,000 cash payment, but he is entitled to depletion on such retained interest. By the "carried interest" arrangement between C and D, the former converts a depletable economic interest in oil in place into a nondepletable contractual right to share in D's net income after recoupment by D of all development costs and expenses. Had C received a cash payment, it would have represented proceeds realized upon the sale of a capital asset by him. E, irrespective of words purporting to convey ownership of oil in place, acquired a depletable economic interest to the extent of his oil payment right for a capital investment measured by the expenditure made by him in drilling and equipping the well. F acquired a like interest for the $15,000 furnished by him to D for development purposes. His interest would have been the same had D not been pledged to expend the $15,000 for development. In that event, however, the transaction would not have been only an investment of the stated sum by F but a sale of an oil payment interest by D, and the latter would have been required to allocate thereto a part of his basis and compute gain or loss. D, of course, acquired an economic interest consisting of the seven-eighths working interest, less the oil payment rights agreed upon by him or his predecessors and held by A, B, E, and F. His invested capital account does not include the investment sums contributed by E or F under their contracts with him, but it does include the amount "advanced" by him for C's share of capitalized development cost.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

SECTION 19.23(m)–4: Computation of depletion based on a percentage of income in the case of oil and gas wells. 1941–25–10751 G. C. M. 22689

INTERNAL REVENUE CODE.

Costs incurred in the business of exploiting a natural resource (including maintenance of geological and land departments), if properly deductible in computing net income, are also deductible in computing net income from the property for the purpose of determining the net income limitation on percentage depletion. Expenses which are not attributable to a particular producing property must be fairly allocated to the several producing properties. Where such costs have been properly capitalized, any loss deduction resulting therefrom, taken in computing net income, must also be included as a deduction in computing net income from the property for the purpose of the net income limitation.

An opinion is requested in connection with the determination of the net income limitation on percentage depletion under section 114(b)(3) and (4) of the Internal Revenue Code whether, in the light of recent decisions of the Board of Tax Appeals subsequent to the decision in *Helvering* v. *Wilshire Oil Co., Inc.* (308 U. S., 90, Ct. D. 1424, C. B. 1939–2, 213), the cost of maintaining geological and land departments and the salaries of officers and employees engaged in similar activities should be capitalized to the extent that their efforts result in the acquisition of new properties, whether such costs should be considered as overhead expenses applicable to the general business of producing oil and gas, or whether such departments should be considered a distinct activity not necessarily supported by production.

Section 114(b)(3) and (4) of the Code provides in part as follows:

(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

(4) PERCENTAGE DEPLETION FOR COAL AND METAL MINES AND SULPHUR.—The allowance for depletion under section 23(m) shall be, in the case of coal mines, 5 per centum, in the case of metal mines, 15 per centum, and, in the case of sulphur mines or deposits, 23 per centum, of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property. * * *

As stated by the United States Supreme Court in its opinion in the Wilshire case, the question presented was whether the taxpayer "in computing its net income * * * for the purpose of applying the 50 per cent limitation on depletion allowance * * * may refuse to take as deductions certain development expenditures, where it has deducted those development expenditures in computing its taxable net income * * *." The taxpayer had exercised its option to treat such development expenses as items deductible from gross income. After paraphrasing the pertinent provisions of the applicable regulations (similar to section 19.23(m)–1(*g*) of Regulations 103), the Court held that such regulations required the taxpayer to deduct such

development expenses in computing its net income for purposes of the limitation on the percentage depletion allowance.

It appears that the Board of Tax Appeals regards that decision as controlling the treatment of all expenses incurred by a taxpayer in the business of producing natural resources. In *Mirabel Quicksilver Co.* v. *Commissioner* (41 B. T. A., 401), where the question for determination was whether interest and capital stock taxes should be deducted from gross income in computing net income for depletion purposes pursuant to section 114(b)4 of the Revenue Act of 1936, the Board stated in part as follows:

* * * The petitioner is engaged solely in the mining of cinnabar, the chief ore producing mercury or quicksilver. The money borrowed was used to develop its mines and to provide plant and equipment for the production therefrom. *The taxes were paid as a necessary condition to the petitioner's continuance in business. Both expenditures bear a direct relation to the petitioner's operations and the production from its property for the taxable year and must be deducted in computing its net income for depletion purposes under the statute.* [Italics supplied.]

In *Montreal Mining Co.* v. *Commissioner* (41 B. T. A., 399), where the petitioner contended that silicosis claims were not deductible from its gross income in computing percentage depletion under the provisions of section 114(b)4 of the Revenue Act of 1934, the Board stated:

The petitioner's position here is similar to that of the respondent in *Helvering* v. *Wilshire Oil Co.* (308 U. S., 90). In that case the taxpayer, consistent with a previously made election, took as deductions in the taxable year development expenses which were incurred in prior years. Such expenses had no direct relation to the production of oil from the taxpayer's property during the taxable years. So here, the settlement of silicosis claims was, under the requirements of the Wisconsin Workmen's Compensation Act, a normal incident in the operation of petitioner's iron mines. While the contraction of the disease had no direct relation to the current year's output, the disease itself directly grew from and had an immediate relation to the petitioner's mining operations. The payment of silicosis claims must be placed in the same category as the development expenses which the Supreme Court held in the Wilshire Oil Co. case are required to be deducted from gross income in computing net income for depletion purposes. In line with and upon the authority of the decision in the Wilshire Oil Co. case, we sustain the respondent's action.

Similarly, in *Grison Oil Corporation* v. *Commissioner* (42 B. T. A., 1117), where the question was whether income taxes paid by the petitioner to the State of Oklahoma should be deducted from gross income in computing net income for depletion purposes, the Board said:

In *Helvering* v. *Wilshire Oil Co.* (308 U. S., 90), the Supreme Court approved respondent's regulations under the 1928 Revenue Act, which required that development expense deducted in computing taxable net income should also be deducted in computing net income from the property for the purpose of applying the 50 per cent limitation on percentage depletion. The Oklahoma income tax here involved comes within the class of deductions from gross income allowable in determining taxable net income under the Federal Revenue Acts, and is no less attributable to the oil property upon which the depletion is claimed than development expense. Under generally recognized rules, both items are properly to be taken into account in computing the net operating profits, as well as the taxable net income, derived from the property by petitioner. Any other conclusion, we think, would be incompatible with the rationale of the Supreme Court's opinion in the Wilshire case. Whether a State income tax based only in part upon income from the mineral property upon which depletion is claimed should be allocated in proportionate part to such property in computing the limitation on the depletion allowance, we need not here decide, since under the facts adduced such question does not arise.

Subsequent to the Wilshire case and in addition to those cases referred to above, other cases have been decided by the Board of Tax Appeals holding various expenses deductible from gross income in computing net income for purposes of the limitation on the percentage depletion allowance. (See *St. Marys Oil & Gas Co.* v. *Commissioner*, 42 B. T. A., 270; *Lumachi Coal Co.* v. *Commissioner*, memo. opinion, dated June 15, 1940, Docket No. 93650; and *Sheridan-Wyoming Coal Co., Inc.*, v. *Commissioner*, memo. opinion, dated June 24, 1940, Docket No. 96906.) Apparently, the theory of those cases is that such items are attributable to the taxpayer's general operations incident to the production of natural resources. It follows that the instant costs, if they represent expenses rather than capital items, should be deducted from gross income for the purpose of computing the percentage depletion allowance. Under such circumstances, it seems apparent that the geological and land departments are not to be considered as a distinct activity not necessarily supported by the production of natural resources.

In view of the foregoing, it is the opinion of this office that all deductible items of a business of exploiting a natural resource must be attributed to that activity. If not directly attributable to a particular producing property, they must be fairly allocated to the several producing properties. In the case of a taxpayer engaged in exploiting natural resources and in other income producing activities, deductible items relating to the several activities must be fairly apportioned between the production of natural resources and the additional activities, as provided in section 19.23(m)-1(*g*) of Regulations 103. In short, any deductions used in computing taxable net income, if properly attributable to the general production of natural resources, must be used in computing net income from the property for the purpose of the percentage depletion allowance. In the event that any expenditures which are properly attributable to the production of natural resources are capitalized, any loss deduction resulting therefrom, taken in computing taxable net income, must also be included as a deduction in computing net income from the property for the purpose of the limitation on the percentage depletion allowance.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

SECTION 19.23(m)-9: Determination of mineral contents of mines and of oil or gas wells. 1941-26-10759 T. D. 5054

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PARTS 3, 9, AND 19.—INCOME TAX.

Amending section 19.23(m)-9 of Regulations 103 and the corresponding provisions of Regulations 101, 94, 86, and 77 relative to revised estimates of mineral contents of mines and of oil or gas wells.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

The last paragraph of section 23(m)-9 of Regulations 103 [Part 19, Title 26, Code of Federal Regulations, 1940 Sup.], of article

23(m)–9 of Regulations 101 [section 9.23(m)–9, Title 26, Code of Federal Regulations, 1939 Sup.], of article 23(m)–9 of Regulations 94 [section 3.23(m)–9, Title 26, Code of Federal Regulations], of article 23(m)–9 of Regulations 86, and of article 229 of Regulations 77 is amended to read as follows:

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

(This Treasury decision is issued under the authority contained in sections 23(m) and 62 of the Internal Revenue Code (53 Stat., 14, 32, 26 U. S. C., Sup. V, 23(m), 62), sections 23(m) and 62 of the Revenue Acts of 1938, 1936, and 1934 (52 Stat., 462, 480, 26 U. S. C., Sup. IV, 23(m), 62; 49 Stat., 1660, 1673, 26 U. S. C., Sup. II, 23(m), 62; 48 Stat., 689, 700, 26 U. S. C., 23(m), 62), and sections 23(l) and 62 of the Revenue Act of 1932 (47 Stat., 181, 191).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved June 21, 1941.

HERBERT E. GASTON,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register June 24, 1941, 11.29 a. m.)

SECTION 19.23(m)–16: Charges to capital and to expense in the case of oil and gas wells. 1941–5–10577 G. C. M. 22332

INTERNAL REVENUE CODE.

Costs incurred by a driller in drilling an oil well on the property of another for cash and an oil payment right or an undivided share in the operating rights should be allocated between the cash and such rights. That part of the costs allocable to the cash is deductible in the year incurred as a business expense. That part of the costs allocable to the oil payment right is returnable only by depletion allowances. That part of the costs allocated to the undivided share in the operating rights should further be allocated between depletable and depreciable expenditures, and is recoverable by depletion and depreciation allowances. The oil payment right and the undivided share in the operating rights so acquired are separate properties.

An opinion is requested whether for Federal income tax purposes the cost of drilling an oil well should be allocated between the cash and property received as consideration for the drilling, or whether the cash should be first offset against the cost and any excess be considered profit and any deficit be considered the cost of the property acquired.

The first situation concerning which an opinion is desired is as follows:

A taxpayer contracts to drill a well for another party, usually a lessee, in consideration of which he is to receive $20,000 in cash and an oil payment in the sum of $20,000, which has a fair market value of $10,000. The cost to the taxpayer of drilling the well is $30,000. By allocating the cost of drilling between the cash and the oil payment received, based on its fair market value at the time of the contract, two-thirds of the cost, or $20,000, is attributable to the cash received and is deductible as a business expense, and one-third thereof, or $10,000, is attributable to the oil payment as the cost thereof and is returnable only through depletion. The following are the results for income tax purposes:

First year:		
Income (cash received)		$20,000
Business expense		20,000
Profit		None
Second year:		
Income (from oil payment)		20,000
Cost	$10,000	
Percentage depletion	5,500	
Deductible		10,000
Profit		10,000

Based on *Anderson* v. *Helvering* (310 U. S., 404, Ct. D. 1456, C. B. 1940–1, 108), this office is of the opinion that in the illustration above the taxpayer, by virtue of his receipt of the oil payment right, became the holder of an economic interest in the oil and gas and is entitled to depletion allowances on his share of the gross income from production represented by the payments to him. To the extent that the taxpayer contributes the services performed and the cost of materials furnished to the development project in return for the oil payment right, he may be regarded as having made an investment toward exploration and development costs for an agreed share of the production. In determining the extent to which the cost of the drilling represents an investment in the oil payment right, this office is of the opinion that the allocation method, such as outlined above, is proper.

The second situation concerning which an opinion is desired is similar, except that instead of acquiring an oil payment right, the taxpayer acquires an undivided one-half interest in the lease having a then value of $20,000 in addition to the cash consideration of $20,000. In G. C. M. 22224 (C. B. 1940–2, 216) this office held that all of the drilling expenditures made by a driller-assignee of an interest in a lease or fee property in consideration for such interest should be capitalized, regardless of whether the assignment of the interest was made to the assignee prior to or after the drilling of the wells. That conclusion was based on the theory that such assignee by his drilling expenditures made a capital investment in the interest acquired. Thus, the same principle applied in the first situation governs here, and it is proper to allocate the cost of drilling between the cash and the interest in the lease acquired by the taxpayer.

A further problem, not present in the case of the oil payment, is presented where the taxpayer (driller) acquires an undivided interest in the lease. In this case the total cost of drilling was $30,000, of which $14,000 represents depletable capital expenditures and $16,000, cost of depreciable equipment. By allocating the cost of drilling between the cash and the interest in the lease received, it is determined that $15,000 is allocable to the lease interest. However, unlike an oil payment holder, the lease interest holder owns part of the depreciable equipment on the property. It becomes necessary, therefore, to determine what part of the $15,000 allocated to the lease interest is attributable to the depletable capital account and what part to the depreciable capital account. The method employed is to allocate the entire capital base of the lease interest ($15,000) between the depletable and depreciable capital accounts in the ratio that the depletable and depreciable expenditures bear to the total cost of drilling. Thus, 14/30 of $15,000, or $7,000, is allocated to the depletable capital account, while 16/30 of $15,000, or $8,000, is allocated to the depreciable capital account. This office is of the opinion that such method of allocation is proper in determining the depletable and depreciable bases in such cases.

The third situation concerning which an opinion is requested involves a case similar to both the first and second situations, except that the taxpayer receives both an oil payment right and an interest in the lease in addition to cash. Allocation of the total cost of drilling is made between these three acquisitions on the basis of their proportionate values at the time of the contract in the same manner as outlined in the first two situations. Thus, assuming that the cost of drilling amounted to $40,000, the amount of cash received was $20,000, and the values of the interest in the lease and oil payment were $10,000 each, the allocation of the total cost of drilling would be as follows:

One-half (the ratio of $20,000 cash to $40,000, total value of cash, oil payment, and lease interest) of the total cost of drilling ($40,000), or $20,000, should be allocated to the cash and is deductible from gross income as a business expense.

One-fourth (the ratio of $10,000, the value of the interest in the lease, to $40,000, total value of cash, oil payment, and lease interest) of the total cost of drilling ($40,000), or $10,000, should be allocated to the lease interest as its capital basis, which in turn should be allocated between depletable and depreciable capital accounts in accordance with the method employed in the second situation.

One-fourth (the ratio of $10,000, the value of the oil payment, to $40,000, total value of cash, oil payment, and lease interest) of the total cost of drilling ($40,000), or $10,000, should be allocated to the oil payment as its capital basis.

A further problem is also presented here, that is, whether the oil payment right and lease interest acquired should be treated as two separate properties or as one. This office is of the opinion that the two rights acquired should be treated as separate properties, as was done in the third situation presented above. Here not only are the

oil payment right and the lease interest depletable interests in the property, but they are dissimilar and adverse interests. An oil payment right burdens the working interest out of which it is carved and expires when it yields the stated amount of oil or oil proceeds. The lease interest does not expire until the termination of the lease itself. This office, therefore, is of the opinion that the oil payment right and the interest in the lease are separate properties. The fact that both interests are acquired at the same time is immaterial.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

SECTION 24.—ITEMS NOT DEDUCTIBLE.

INTERNAL REVENUE CODE.

Loss on sale of "National Defense Series" obligations. (See I. T. 3475, page 199.)

SECTION 19.24–2: Capital expenditures. 1941–16–10684
(Also Section 23(c), Section 19.23(c)–1.) I. T. 3468

INTERNAL REVENUE CODE.

Filing fees required to be paid by corporations under section 21.201 of the Michigan Statutes Annotated for filing, examining, and certifying articles of incorporation constitute capital expenditures and are not deductible from gross income for Federal income tax purposes.

Franchise fees required to be paid under section 21.203 of the Michigan Statutes Annotated upon incorporation of Michigan corporations, or upon application for admission by foreign corporations, for the privilege of exercising their corporate franchises within the State, are deductible from gross income as taxes under section 23(c) of the Internal Revenue Code.

Advice is requested as to the treatment for Federal income tax purposes of (1) filing fees, and (2) franchise fees required to be paid under the Michigan statutes by domestic and foreign corporations for the privilege of exercising their corporate franchises within that State.

Section 10136 of the 1929 Compiled Statutes of Michigan corresponds to section 21.201, volume 15, of the Michigan Statutes Annotated, which provides as follows:

SEC. 21.201. *Filing and miscellaneous fees; disposition.*

Section 1. Hereafter the fees to be paid to the secretary of state by or in behalf of corporations, for the purposes herein specified shall be as follows: For filing, examining and certifying articles of domestic corporations five (5) dollars; for filing and examining articles or certificates of incorporation, and other papers connected with the application of a foreign corporation for admission to do business in Michigan, ten (10) dollars; * * * all of which fees shall be paid by the corporation at the time of filing or when the service is rendered by the secretary of state. All such fees shall be in addition to the franchise fees prescribed in this act, and shall, when collected, be covered into the treasury of the State, and there be credited to the general fund.

Section 10138 of the 1929 Compiled Statutes corresponds to section 21.203, volume 15, of the Michigan Statutes Annotated, which provides that:

SEC. 21.203. *Franchise fee of profit corporation; amount; increase in capital stock, foreign corporations; building and loan corporations; corporation defined.*
SEC. 3. Every domestic corporation hereafter organized for profit, and every foreign corporation for profit hereafter applying for admission to do business within this State, shall at the time of filing its articles or applying for admission, as the case may be, pay to the secretary of State, as an organization fee and for the privilege of exercising its franchises within this State, a sum equal to one-half (½) mill upon the dollar for each dollar of the authorized capital stock of such corporation; and each corporation heretofore or hereafter incorporated under the laws of or admitted to do business in this State, shall pay a proportionate fee upon each and any increase in its authorized capital stock made subsequent to the passage of this act; * * * All corporations whose terms of corporate existence shall have expired, or shall be about to expire by limitation, and who shall seek to extend or renew such corporate existence, in accordance with law, shall be regarded as new corporations for the purpose of the payment of the fees provided by this act, and shall be required to pay such fees before the extension or renewal of such corporate existence.

The filing fees required under section 21.201, supra, to be paid by corporations to the secretary of state of Michigan for filing, examining, and certifying their articles of incorporation are organization expenses and, therefore, constitute capital expenditures which are not deductible from gross income for Federal income tax purposes. (Section 19.24–2 of Regulations 103.)

Franchise fees provided for under section 21.203, supra, and paid by domestic corporations to the secretary of state of Michigan at the time of incorporation, or paid by foreign corporations upon applying for admission, as the case may be, for the privilege of exercising their corporate franchises within the State of Michigan, are allowable deductions as taxes under section 23(c) of the Internal Revenue Code.

SECTION 25.—CREDITS OF INDIVIDUAL AGAINST NET INCOME.

SECTION 19.25–2: Earned income credit. 1941–12–10651
I. T. 3458

INTERNAL REVENUE CODE.

In computing the earned income credit for Federal income tax purposes, the tax of 1½ per cent imposed by the city of Philadelphia upon salaries, wages, or other compensation is not "properly allocable to or chargeable against" the salary received by A in 1940.

Advice is requested whether the 1½ per cent tax imposed by the city of Philadelphia upon salaries, wages, and other compensation is "properly allocable to or chargeable against" the salary received by A in 1940 in the amount of $4x$ dollars for the purpose of computing his earned income credit. In addition to his salary of $4x$ dollars, A had investment income in excess of the tax imposed upon his salary, which tax was the only deduction claimed.

The tax in question is imposed under an income tax ordinance approved by the mayor December 13, 1939. Section 2 of the ordinance provides in part as follows:

An annual tax for general revenue purposes of 1½ per centum is hereby imposed on (*a*) salaries, wages, commissions and other compensation earned after January 1, 1940, by residents of Philadelphia; and on (*b*) salaries, wages, commissions and other compensation earned after January 1, 1940, by nonresidents of Philadelphia for work done or services performed or rendered in Philadelphia; and on (*c*) the net profits earned after January 1, 1939, of businesses, professions or activities conducted by such residents, and on (*d*) the net profits earned after January 1, 1939, of businesses, professions or other activities conducted in Philadelphia by nonresidents.

Section 3 of the ordinance provides for the filing of a return with the receiver of taxes by each person whose earnings or profits are subject to the tax. Section 4 of the ordinance provides for the withholding of the tax, making it the duty of the employer to deduct monthly the tax of 1½ per cent on the salary, wage, or other compensation due from the employer to the employee.

The tax imposed by the city of Philadelphia under the above-mentioned ordinance is an income tax. Section 23(c) of the Internal Revenue Code provides for the deduction in computing net income of "Taxes paid or accrued within the taxable year" with certain exceptions not here material. Consequently, the income tax imposed by the city of Philadelphia is an allowable deduction for Federal income tax purposes. (I. T. 3370, C. B. 1940-1, 32; I. T. 3382, C. B. 1940-1, 12.) "Earned net income" is defined in section 25(a)4(C) of the Code to mean "the excess of the amount of the earned income over the sum of the earned income deductions," and the term "Earned income deductions" is defined in section 25(a)4(B) to mean "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.*" [Italics supplied.]

The tax here in question is not "properly allocable to or chargeable against" the earned income in the sense that it is incurred in earning the income. (Cf. Mimeograph 3283, C. B. IV-1, 14 (1925).) The earned net income on which the earned income credit is based is A's salary of 4*x* dollars not reduced by the amount of the tax imposed by the city of Philadelphia.

SECTION 27(c).—CORPORATION DIVIDENDS PAID CREDIT: DIVIDEND CARRY-OVER.

SECTION 19.27(c)-1: Dividend carry-over. (Also Section 504, Section 19.504-1; Section 506. Section 19.506-6.) 1941-24-10747 T. D. 5052

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 19.—INCOME TAX.

Regulations 103 amended to conform to provisions of Public Law 18 (Seventy-seventh Congress), which amended the Internal Revenue Code so as to correct certain miscellaneous errors.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and others concerned:

In order to conform Regulations 103 [Part 19, Title 26, Code of Federal Regulations, 1940 Sup.] to the provisions of Public Law 18 (Seventy-seventh Congress), approved March 17, 1941, which corrected certain miscellaneous errors of a clerical nature in the Internal Revenue Code, such regulations are amended as follows:

PARAGRAPH 1. The following is inserted immediately preceding section 19.27(c)–1:

PUBLIC LAW 18 (APPROVED MARCH 17, 1941).

Resolved * * * That the Internal Revenue Code, as amended, be amended as follows:

In section 27(c), insert "1936 or" before "1937".

* * * * * * *

SEC. 2. The sections of the Internal Revenue Code amended by this joint resolution shall have effect as if such sections, as so amended, had been enacted in the Internal Revenue Code on February 10, 1939.

PAR. 2. The words "1936 or" are inserted in the second paragraph of section 19.27(c)–1 immediately preceding "1937".

PAR. 3. The following is inserted immediately preceding section 19.113(a)(11)–1:

PUBLIC LAW 18 (APPROVED MARCH 17, 1941).

Resolved * * * That the Internal Revenue Code, as amended, be amended as follows:

* * * * * * *

In section 113(a)(11), insert "or the Revenue Act of 1938, 52 Stat. 508," after "49 Stat. 1698,".

In section 113(a)(11), insert "or the Revenue Act of 1938" at the end of the third sentence and after "the Revenue Act of 1936" wherever it appears in the last sentence.

* * * * * * *

SEC. 2. The sections of the Internal Revenue Code amended by this joint resolution shall have effect as if such sections, as so amended, had been enacted in the Internal Revenue Code on February 10, 1939.

PAR. 4. The following is inserted immediately preceding section 19.504–1:

PUBLIC LAW 18 (APPROVED MARCH 17, 1941).

Resolved * * * That the Internal Revenue Code, as amended, be amended as follows:

* * * * * * *

In section 504(a), insert "or of section 405 of the Revenue Act of 1938" after "subsection (c) of this section".

In section 504(a), insert "or under Title IA of the Revenue Act of 1938" after "under this subchapter".

In section 504(a), insert "beginning after December 31, 1937" after "any preceding taxable year".

In section 504(b), strike out the period at the end of the subsection and insert in lieu thereof a semicolon.

In section 504(c)(3)(A), insert before the closing mark of parenthesis the following: "or, in the case of a taxable year beginning in

1939, by the amount allowed under section 405(c) of the Revenue Act of 1938 in the computation of the tax under Title IA of such Act for a taxable year beginning prior to January 1, 1939".

* * * * * * *

SEC. 2. The sections of the Internal Revenue Code amended by this joint resolution shall have effect as if such sections, as so amended, had been enacted in the Internal Revenue Code on February 10, 1939.

PAR. 5. The second sentence of section 19.504–1 is amended to read as follows:

In computing the dividends paid credit for the purposes of subchapter A of chapter 2, the amount allowed under section 504(c) of the Internal Revenue Code, as amended, or section 405(c) of the Revenue Act of 1938 in the computation of the tax under subchapter A of chapter 2 or under Title IA of the Revenue Act of 1938 for any preceding taxable year beginning after December 31, 1937, is considered a dividend paid in such preceding taxable year and not in the year of distribution.

PAR. 6. The following is inserted immediately preceding section 19.506–1:

PUBLIC LAW 18 (APPROVED MARCH 17, 1941).

Resolved * * * That the Internal Revenue Code, as amended, be amended as follows:

* * * * * * *

In section 506(c)(2)(A), insert after ", or both," the following: "of this section or section 407 of the Revenue Act of 1938,".

In section 506(c)(2)(B), insert after ", or both," the following: ", of this section or section 407 of the Revenue Act of 1938,".

* * * * * * *

SEC. 2. The sections of the Internal Revenue Code amended by this joint resolution shall have effect as if such sections, as so amended, had been enacted in the Internal Revenue Code on February 10, 1939.

PAR. 7. The last sentence of section 19.506–6 is amended to read as follows:

If a corporation claims and receives the benefit of the provisions of section 506 of the Internal Revenue Code or section 407 of the Revenue Act of 1938 based upon a distribution of "deficiency dividends," that distribution does not become a part of the basic surtax credit for the purposes of subchapter A of chapter 2; nor is it made the basis of the 2½-month carry-back credit provided for in section 504(c) of the Internal Revenue Code or in section 405(c) of the Revenue Act of 1938.

(This Treasury decision is issued under the authority contained in Public Law 18 (Seventy-seventh Congress) and section 62 of the Internal Revenue Code.)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved June 10, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register June 12 1941, 11.26 a. m.)

PART IV.—ACCOUNTING PERIODS AND METHODS OF ACCOUNTING.

SECTION 41.—GENERAL RULE.

SECTION 19.41–1: Computation of net income. 1941–4–10572
I. T. 3444

INTERNAL REVENUE CODE.

The following rates of exchange are accepted by the Bureau of Internal Revenue as the current market rates of exchange prevailing as of December 31, 1940:

Country or city.	Monetary unit.	Value in terms of United States money.	Country or city.	Monetary unit.	Value in terms of United States money
Argentina	Peso	$0.297733	Japan	Yen	$0.234387
Australia	Pound	[1] 3.228000	Mexico	Peso	.204750
Belgium	Belga	[2]	Netherlands	Guilder	[2]
Brazil	Milreis	[1] .060575	New Zealand	Pound	3.227500
British India	Rupee	.301783	Norway	Krone	[2]
Bulgaria	Lev	[2]	Panama	Balboa	1.000000
Canada	Dollar	[1] .909090	Peru	Sol	.156900
Chile	Peso	[1] .051660	Philippine Islands	Peso	.500000
China (Shanghai)	Yuan	.054106	Poland	Zloty	[2]
Colombia	Peso	.572350	Portugal	Escudo	.039990
Cuba	Peso	.910000	Rumania	Leu	[2]
Denmark	Krone	[2]	South Africa	Pound	3.980000
England	Pound	[1] 4.035000	Spain	Peseta	.091300
Finland	Markka	.020116	Straits Settlements	Dollar	.471000
France	Franc	[2]	Sweden	Krona	.238235
Germany	Reichsmark	.399820	Switzerland	Franc	.232064
Greece	Drachma	[2]	Uruguay	Peso	[3] .658300
Hong Kong	Dollar	.236187	Venezuela	Bolivar	.310000
Hungary	Pengo	.197700	Yugoslavia	Dinar	.022400
Italy	Lira	.050483			

[1] Official rate. [2] No rate available. [3] Controlled rate.

SECTION 19.41–1: Computation of net income. 1941–11–10636
I. T. 3457

INTERNAL REVENUE CODE.

The rate of exchange accepted by the Bureau of Internal Revenue for the French franc as of December 31, 1940, is $0.0228.

SECTION 19.41–1: Computation of net income. 1941–12–10652
(Also Section 19.42–4.) I. T. 3459

INTERNAL REVENUE CODE.

Where under the terms of a fixed-fee Government contract frequent payments are to be made to the contractor to cover costs of construction incurred by the contractor plus an amount computed on such costs on account of the fixed fee, and as such payments are made the parts constructed and materials on account of which such payments are made immediately become the sole property of the United States, the income to the contractor from the contract accrues in the taxable years in which the income is earned and the right of the taxpayer to payment therefor is fixed. In order clearly to reflect the net income, the gross income from the contract and from other

contracts of this type, including the so-called reimbursements of cost, should be reported by the taxpayer (reporting on the accrual basis) in the returns for the taxable years in which the income accrues, and there should be allowed as deductions therefrom the costs or expenses which are related to such gross income. This conclusion does not affect the taxpayer's present method of reporting the income from long-term contracts which may properly be reported on the completed contract basis.

Advice is requested by the M Company relative to the proper method of reporting income from a certain type of Government contract for the purpose of Federal income taxation.

The taxpayer keeps its accounts and files its returns on the accrual basis and regularly reports its income from long term contracts for the taxable year in which each such contract is completed. It believes, however, that the completed contract basis will not be satisfactory under the terms of the particular Government contract here under consideration.

The contract in question specifies an amount of estimated aggregate cost upon the basis of which a specified fixed fee for its profit is to be paid to the M Company, the contractor. It provides for semi-monthly payments (or more frequently, if justified) as earned to cover costs of construction incurred by the contractor, plus an amount computed on such costs on account of the fixed fee. The payments on account of the fixed fee are to be continued until the total amount paid equals a designated figure. The remainder of the fixed fee, less a designated reserve, is to be paid upon preliminary acceptance of the article constructed, and such reserve is to be paid upon final acceptance. An increase of the fixed fee is provided for in event that the Government increases the cost, and a bonus is provided for accelerated delivery and for saving in cost, the sum of all bonuses not to exceed a designated amount. As payments of cost and fixed fee are made by the Government, all parts constructed and materials on account of which such payments have been made immediately become the sole property of the United States, but this provision is not construed as relieving the contractor from the responsibility for the care and protection of materials and work upon which payments have been made or as a waiver of the right of the Government to require fulfillment of all the terms of the contract. The actual cost of correcting all defects and deficiencies for which the contractor is held responsible is to be deducted from the payment in final settlement.

Upon consideration of the terms of the contract in question, the Bureau is of the opinion that the income from the contract accrues in the taxable years in which the income is earned and the right of the taxpayer to payment therefor is fixed. Therefore, it is held, in order clearly to reflect the net income, that the gross income from the contract and from other contracts of this type, including the so-called reimbursements of cost, should be reported by the taxpayer (reporting on the accrual basis) in the returns for the taxable years in which the income accrues, and there should be allowed as deductions therefrom the costs or expenses which are properly allowable as deductions under the applicable income or excess profits tax law and which are related to such gross income. (See sections 41 and 43 of the Internal

Revenue Code and sections 19.41–1 and 19.43–1 of Regulations 103.) In regard to the maintenance and the preservation of adequate accounting records, see sections 41 and 54 of the Internal Revenue Code and sections 19.41–3 and 19.54–1 of Regulations 103.

This ruling is without effect upon the taxpayer's present method of reporting the income from long term contracts which may properly be reported on the completed contract basis.

SECTION 19.41–4: Accounting period. 1941–15–10672
I. T. 3466

INTERNAL REVENUE CODE.

The M Company, incorporated under the laws of Ohio, on November 3, 1939, is not entitled to file its Federal income tax return on the basis of a fiscal year ended November 30, 1940, as it did not file a first return for the period ended November 30, 1939, and a fiscal year has not been established in accordance with the regulations. The corporation must file its returns on a calendar year basis until a fiscal year has been properly established.

Advice is requested whether the M Company may file its Federal income tax returns on the basis of fiscal years ending November 30, under the circumstances herein set forth.

The articles of incorporation of the M Company (an Ohio corporation), dated November 1, 1939, were filed on November 3, 1939. It did not perfect its organization until December 18, 1939, when the by-laws of the corporation were adopted, the officers and directors of the corporation elected, and, pursuant to the articles of incorporation, the amount of $500 deposited in a bank, representing the capital with which the corporation commenced business, as required by section 8623–13 of the General Corporation Act of the State of Ohio. On the following day the corporation issued its stock. It appears that prior to December 18, 1939, the corporation transacted no business and had no income.

At a special meeting of the board of directors of the corporation held on May 1, 1940, counsel for the corporation advised the board that, unless otherwise fixed by the board, the corporation's fiscal year would automatically be the calendar year, after which the following resolution was adopted:

Resolved, that the fiscal year of this corporation be and the same is hereby fixed from December the 1st to November the 30th of each year.

It is contended that the corporation should be permitted to file its first return for the fiscal year ended November 30, 1940, since the establishment on May 1, 1940, of the corporation's fiscal year ended November 30, 1940, was made during the corporation's first year of business, even though its articles of incorporation were filed more than one year prior to November 30, 1940.

The first question for determination is whether the corporation's existence began (1) on the date of filing the articles of incorporation, viz, November 3, 1939, or (2) when it had perfected its organization and first transacted business, viz, on December 18, 1939. If the corporation's existence can be said to date from the time it perfected its

organization and first transacted business, then the corporation's first fiscal year could properly be considered as ending on November 30, 1940, for which year a return would be due on February 15, 1941. However, if the corporation's existence began on November 3, 1939, the date of filing its articles of incorporation, then a return for the period ended November 30, 1940, would cover a period of more than 12 months, no return having been filed for the period November 3, 1939, to November 30, 1939. A return covering a period of more than 12 months is expressly prohibited by section 19.47–1 of Regulations 103, which provides that "No return can be made for a period of more than 12 months."

Section 8623–4 of the General Corporation Act of the State of Ohio provides for the incorporation of corporations within that State. Section 8623–7 of that act reads as follows:

When corporate existence begins.—Upon the filing of the articles the incorporators and their associates, successors and assigns by the name stated herein, shall, from the date of such filing, be and constitute a body corporate, with perpetual succession.

Such section clearly fixes the date upon which the corporation becomes a body corporate, even though it is not authorized to commence business until the amount of capital stated in the articles of incorporation as that with which it will begin business has been paid in.

It is provided in section 19.52–1 of Regulations 103 that (1) a corporation having an existence during any portion of a taxable year is required to make a return; (2) that 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; and (3) that in the absence of a proper showing to the collector, such a corporation will be required to make a return. Section 19.41–4 of such regulations states that "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," and that "A person having no such fiscal year must make his return on the basis of the calendar year."

In view of the foregoing, it is held that the corporation's first taxable year began on November 3, 1939, the date upon which the articles of incorporation were filed, and that in order to establish the corporation's fiscal year as ending "November the 30th of each year" the necessary action was required, under section 19.41–4, supra, to be taken on or before November 30, 1939. Since such action was not taken, nor was a fiscal year ending within the first 12 months of the corporation's existence established during such period, it is held that the corporation must make and file its Federal income tax returns on the calendar year basis until such time as it makes a timely application for a change of accounting period under the provisions of section 46 of the Internal Revenue Code. Consequently, a return for the period November 3, 1939, to December 31, 1939, is required to be filed, even though the corporation had no income for such period. (Cf. O. D. 1120, C. B. 5, 233 (1921).)

SECTION 42.—PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

SECTION 19.42-1: When included in gross income. 1941-26-10756
I. T. 3485

INTERNAL REVENUE CODE.

Where a taxpayer keeping his books and filing his returns on the cash receipts and disbursements basis enters into a contract on December 31 to sell stock on a stock exchange for more than the basis thereof, the gain derived is not returnable for Federal income tax purposes until the taxpayer has actually or constructively received cash or its equivalent under the contract of sale.
I. T. 3323 (C. B. 1939-2, 90) modified.

Advice is requested with respect to the applicability of I. T. 3323 (C. B. 1939-2, 90) to a taxpayer keeping his accounts on the cash receipts and disbursements basis who derives a gain from securities sold on December 31, where delivery is not made, nor payment of the sale price received, until the following year.

I. T. 3323, supra, was based on G. C. M. 21503 (C. B. 1939-2, 205), in which it was held that where a contract to sell stock on a stock exchange for less than the basis thereof was entered into on December 31, 1930, and delivery of the stock was made in the regular way on January 2, 1931, the loss on the transaction was incurred in the year 1930 and constitutes a proper deduction for that year. In I. T. 3323, supra, it was held that the rule laid down in G. C. M. 21503, supra, with respect to a loss applies equally to a similar transaction in which gain is realized, and that, therefore, such gain is returnable for Federal income tax purposes for the year in which the transaction was consummated except for delivery of the stock.

Further consideration has been given to the question covered by I. T. 3323, supra, in connection with the decision of the Board of Tax Appeals (involving a similar situation) in *Harden F. Taylor et ux.* v. *Commissioner* (43 B. T. A., 563, acquiescence in this issue [page 10, this Bulletin]), wherein the Board held (syllabus) "Where sales [of securities] were made on last two days of 1936 but deliveries, settlement, and payment of the sale price were made in 1937, the gain is not realized in 1936 by one on a cash basis."

Although with respect to a taxpayer reporting on the accrual basis it appears correct to say that such a gain is returnable in the year in which the contract of sale was entered into and, therefore, the purchaser's legal obligation to make payment to the taxpayer became reasonably certain in fact and ascertainable in amount (*Spring City Foundry Co.* v. *Commissioner*, 292 U. S., 182, Ct. D. 829, C. B. XIII-1, 281 (1934); *Lucas* v. *North Texas Lumber Co.*, 281 U. S., 11, Ct. D. 169, C. B. IX-1, 294 (1930)), nevertheless, as to a taxpayer reporting on the cash receipts and disbursements basis, the gain would appear to be returnable only in the year in which the seller has actually or constructively received cash or an equivalent under the contract of sale. (Section 42, Internal Revenue Code.)

Accordingly, I. T. 3323, supra, is modified by substituting the following for the last paragraph thereof:

It is held that as to a taxpayer reporting on the accrual basis the rule laid down in G. C. M. 21503, supra, with respect to a loss applies equally to a similar situation in which gain is realized. (See *Spring City Foundry Co.* v.

Commissioner, 292 U. S., 182, Ct. D. 829, C. B. XIII–1, 281 (1934); *Lucas* v. *North Texas Lumber Co.*, 281 U. S., 11, Ct. D. 169, C. B. IX–1, 294 (1930).) As to a taxpayer reporting on the cash receipts and disbursements basis, however, the gain is not returnable until he has actually or constructively received cash or an equivalent under the contract of sale. (See section 42, Internal Revenue Code.)

SECTION 19.42–4: Long-term contracts.

INTERNAL REVENUE CODE.

Fixed-fee Government contract. (See I. T. 3459, page 236.)

SECTION 43.—PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

SECTION 19.43–2: When charges deductible. 1941–7–10597
I. T. 3450

INTERNAL REVENUE CODE.

Where a property owner sustains a loss by reason of failure to redeem land sold to the State of Michigan for delinquent taxes, his loss is deductible for Federal income tax purposes in the taxable year during which the 18-month period for redemption expires, regardless of the fact that the property was subsequently redeemed by the municipality for the benefit of the owner under Act No. 155 of the Public Acts of Michigan, as amended.

Advice is requested relative to the effect of the decision of the Supreme Court of Michigan in the case of *Sparks* v. *Auditor General* (292 Mich., 58, 290 N. W., 327) on the application of the general rule that acquisition of a taxpayer's property by the State of Michigan under a tax sale does not give rise to a loss for Federal income tax purposes until the expiration of the redemption period.

In the Sparks case, supra, the owner of land which was sold for delinquent taxes on May 3, 1938, made no effort to pay the delinquent taxes during the following 18-month redemption period. Upon the expiration of that period, November 3, 1939, title became vested in the State of Michigan, and ordinarily under the provisions of the Michigan statutes this land would have been sold by the State at auction during the following February. However, Act No. 155 of the Public Acts of Michigan, 1937, as amended by Act No. 244, Public Acts, 1939, provides in part that:

SEC. 5. Any municipality may at any time prior to the sale provided for in section 7 of this act make application to the State land office board for the withholding of the lands in said application from the said sale, for a period of one year from the date the title vests in the State, and the said State land office board shall withhold such lands from said sale, which lands shall be held subject to the lien of the city for delinquent taxes and special assessments. In the event the taxes on said lands included in said application are not redeemed or paid by said municipality, such lands shall be offered for sale at the next succeeding sale held the following year * * *.

("Municipality" is defined to include any county, city, village, township, or school district.)

On December 7, 1939, the owner paid to the township treasurer the amount of money for which the land had been sold to the State. That

officer settled with the county treasurer (Mr. Sparks) for the tax item, and the latter tendered the proportion thereof due the State to the auditor general, who refused to accept it, whereupon action was brought to require the auditor general to accept the money tendered for the redemption of the land. In its decision, the Supreme Court of Michigan stated that the section of the amended Act No. 155, supra, does not give the owner an extension of time within which to pay taxes and redeem property after title has become vested in the State, but that if given at all it is given to the municipality and not the owner, and the court could not by construction extend the time or vary the terms of a statute under which the right of redemption from a tax sale may be exercised. The court held, however, that the municipality's right to pay the taxes and redeem the land could be exercised for the benefit of the former owner of the land, and the court stated that where a redemption is made with money paid by the property owner in satisfaction of delinquent taxes, the State should deed the land directly to such former owner.

The State of Michigan becomes the absolute owner of land sold for taxes upon the expiration of the 18-month period for redemption, and the former owner is divested of all right and title thereto on that date. Although a municipality may secure a right to redeem after that date, and although the court held that the municipality's right may be exercised for the benefit of the former property owner, the court also stated that this right to redeem is the sole right of the municipality, and it does not appear that the former owner can compel the municipality to redeem for his benefit.

It is, therefore, the opinion of the Bureau that in cases in which a property owner sustains a loss by reason of failure to redeem land sold to the State of Michigan for delinquent taxes, his loss is deductible for Federal income tax purposes in the taxable year during which the 18-month period for redemption expires; and that the year in which such loss is allowable is not postponed by the Michigan law (as interpreted in the case of *Sparks* v. *Auditor General*, supra), which allows a municipality to redeem the land for the benefit of the property owner subsequent to the expiration of the property owner's 18-month period for redemption. (As to the general rule see G. C. M. 19367, C. B. 1937–2, 115.)

SECTION 46.—CHANGE OF ACCOUNTING PERIOD.

SECTION 19.46–1: Change of accounting period. 1941–26–10760
T. D. 5055

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 19.—INCOME TAX.

Regulations 103, amended.—Change of accounting period.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

Section 19.46–1 of Regulations 103 [Part 19, Title 26, Code of Federal Regulations, 1940 Sup.] is amended by striking out the first sentence thereof reading as follows:

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.—

and by substituting in lieu thereof the following two sentences:

If a taxpayer (other than a subsidiary corporation required to change its accounting period by reason of the provisions of section 33.14 of Regulations 110) 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. If a change of accounting period of a subsidiary is required for excess profits tax purposes under section 33.14 of Regulations 110, the information required on Form 1128 shall be furnished by the subsidiary at or before the time of filing the consolidated excess profits tax return.

(This Treasury decision is prescribed pursuant to sections 46 and 62 of the Internal Revenue Code (53 Stat., 26, 32).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved June 21, 1941.

HERBERT E. GASTON,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register June 24, 1941, 11.29 a. m.)

PART V.—RETURNS AND PAYMENT OF TAX.

SECTION 56.—PAYMENT OF TAX.

SECTION 19.56–1: Date on which tax shall be paid.

INTERNAL REVENUE CODE.

Defense tax where credits against tax equal or exceed total tax liability. (See I. T. 3470, page 191.)

SUBCHAPTER C.—SUPPLEMENTAL PROVISIONS.

SUPPLEMENT A.—RATES OF TAX.

SECTION 101.—EXEMPTIONS FROM TAX ON CORPORATIONS.

SECTION 19.101(6)–1: Religious, charitable, scientific, literary, and educational organizations and community chests. 1941–18–10699 G. C. M. 22554

INTERNAL REVENUE CODE.

The N Association, a corporation organized to provide medical care and hospitalization for its members consisting of civil employees of the executive branch of the United States Government, and deriving its income from membership fees and monthly dues, is not

organized and operated for "charitable purposes" within the purview of section 101(6) of the Internal Revenue Code. However, the association is exempt from Federal income tax under section 101(19) of the Code.

An opinion is requested whether the N Association is exempt from Federal income tax under section 101(6) or section 101(19) of the Internal Revenue Code, the latter section having been added by section 217 of the Revenue Act of 1939.

The N Association, a corporation, was organized to provide medical care and hospitalization for its members by making the necessary arrangements with physicians, hospitals, etc. The association has no capital stock, was not organized for profit, and its membership is restricted to and composed solely of civil employees of the executive branch of the United States Government. Its income is derived from membership fees and monthly dues paid by its members. No part of its net earnings inures to the benefit of any private shareholder or individual, and no substantial part of its activities consists of attempting to influence legislation by propaganda or otherwise.

The association, pursuant to contracts with its members, has procured for them the services of several doctors who devote their full time to the members and their dependents, and one doctor who devotes approximately one-half of his time to this purpose. These doctors are paid by the association in bi-monthly installments for their full or half-time services in accordance with the terms of their contracts with the association. Certain other doctors whose services vary from about half-time to an occasional consultation are also retained by the association, and they are paid on a fee basis. The association maintains and operates clinics at two locations with a full-time staff of registered nurses, technicians, pharmacists, and other employees. An office is maintained for each doctor on the regular staff. These doctors divide their time between consultations in their offices and calls upon patients at their homes or in the hospitals. The association does not own and operate a hospital nor does it intend to undertake the construction and operation of one.

Section 101(6) of the Internal Revenue Code provides in part as follows:

SEC. 101. * * * The following organizations shall be exempt from taxation under this chapter—

Corporations * * * organized and operated exclusively for religious, scientific, literary, or educational 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 * * *.

Based on the above-outlined facts, this office is of the opinion that the N Association is not organized and operated for "charitable purposes" within the purview of section 101(6), supra.

The question remains whether the association meets the tests prescribed by section 101(19), supra. That section provides as follows:

SEC. 101. * * * The following organizations shall be exempt from taxation under this chapter—

Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or their designated beneficiaries, if (A) admission to membership in such association is limited to individuals who are officers

or employees of the United States Government, and (B) no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

It is clear from the evidence presented that the association meets the requirements of the foregoing section unless its method of operation in providing medical and clinical services as heretofore described does not constitute the "payment of life, sick, accident, or other benefits." Stated otherwise, the issue is whether section 101(19) is to be construed to bring within its scope cases in which an association makes direct money payments to its members, or contracts with others to make such payments, and to exclude cases in which an association furnishes benefits to members in the form of medical, clinical, or hospital services. The former type of case is admittedly within the statute.

It is the opinion of this office that where, as here, the association is otherwise within the terms of the statute, exemption should not be denied merely because the benefits to members are in the form of medical, clinical, and hospital services rather than in the form of money payments. It follows that the N Association is exempt from Federal income tax under section 101(19) of the Internal Revenue Code.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

SUPPLEMENT B.—COMPUTATION OF NET INCOME.

SECTION 112(a).—RECOGNITION OF GAIN OR LOSS: GENERAL RULE.

SECTION 19.112(a)–1: Sales or exchanges.

INTERNAL REVENUE CODE.

Exchanges in reorganization under the Bankruptcy Act involving cancellation of indebtedness. (See G. C. M. 22528, page 193.)

SECTION 114.—BASIS FOR DEPRECIATION AND DEPLETION.

ARTICLE 114–1: Basis for allowance of depreciation and depletion. 1941–9–10618 G. C. M. 22106
(Also Section 23(m), Article 23(m)–1.)

REVENUE ACTS OF 1934, 1936, 1938, AND INTERNAL REVENUE CODE.

The term "property," as used in the provisions of the Revenue Act of 1934 and corresponding provisions of subsequent Revenue Acts and of the Internal Revenue Code providing for the allowance of depletion and fixing a basis for the computation of such allowance, means each separate interest owned by the taxpayer in each separate tract or parcel of land, whether separated geographically or by conveyancing. If a taxpayer holds several different interests in the same tract, each interest is a separate property. The right of election as to method of depletion must be exercised with respect to each property in accordance with these general principles.

An opinion is requested regarding the definition of the term "property" and a taxpayer's rights as to election of the method of determining depletion with respect to a "property" under section 114(b)4 of the Revenue Act of 1934, relating to percentage depletion, in certain cases involving minerals. Specific problems are set forth in detail in the latter part of this memorandum.

Section 23(m) of the Revenue Act of 1934 provides in part as follows:

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. * * *

Section 23(n) of the Act provides as follows:

(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. [Italics supplied.]

The term "property" is used in a similar manner in other sections of the Act relating to depletion and in various provisions of Regulations 86, prescribed pursuant to the Revenue Act of 1934.

Article 23(m)-1(*j*) of Regulations 86 provides as follows:

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

Article 23(m)-1(*b*) of Regulations 86 provides:

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 exact meaning of the term "property" as used in the Revenue Act and the applicable articles of the regulations has been considered few times by the courts, and in considering this question they have largely relied upon the wording of the regulations. The case of *Vinton Petroleum Co. of Texas* v. *Commissioner* (71 Fed. (2d), 420, certiorari denied October 15, 1934, 293 U. S., 601, petition for rehearing denied December 17, 1934, 293 U. S., 633) concerned a situation wherein the taxpayer produced oil from wells located on eight different but neighboring tracts of land acquired at different times, some in fee simple, some under leases. The court held that the deduction for depletion was to be estimated separately on the gross income *from each tract* of land and not on the aggregate from all.

(See also *Allie M. Turbeville* v. *Commissioner*, 31 B. T. A., 283, affirmed on other grounds, 84 Fed. (2d), 307, certiorari denied, 299 U. S., 581; and *J. T. Sneed, Jr.*, v. *Commissioner*, 40 B. T. A., 1136.)

The language, "In general 'the property' as the term is used in section 204(c)2 and this article refers to the separate tracts or leases

of the taxpayer," which appeared in article 221 of Regulations 69 relating to the Revenue Act of 1926 (the same language appeared in article 241 of Regulations 74, except that section 114(b)3 of the Revenue Act of 1928 was used in lieu of section 204(c)2 of the Revenue Act of 1926), does not appear in Regulations 77 and 86. It is also true that this language as used in Regulations 69 and 74 referred only to oil and gas properties. However, the court in considering the Vinton case construed article 221(j) of Regulations 77 (which reads the same as article 23(m)–1(*j*) of Regulations 86) as having the same effect as the earlier articles contained in Regulations 69 and 74, and the subsequent articles refer also to mining properties. The decision, then, must be regarded as authoritative in considering the applicable articles of Regulations 77 and 86 and as controlling not only with respect to oil and gas properties but also with respect to coal, metal, and sulphur properties.

The taxpayer's interest, then, in each different tract or parcel of land is a separate "property." The term "tract" or "parcel" of land is used here in the same sense in which it is ordinarily used. Separate "tracts" or "parcels" of land not only exist when two areas or pieces of land are separated geographically, but a single "tract" or "parcel" of land may be divided into two or more separate "tracts" or "parcels" by means of the execution of conveyances or leases carving up the original "tract" or "parcel." If a taxpayer holds several interests in the same tract or parcel, each interest is a "property" within the comprehension of that term as used in the provisions of the Revenue Acts fixing a basis for the computation of depletion. As the basis fixed also governs the computation of gain or loss, it follows that a depletable "property" is also an asset subject to sale or other disposition giving rise to gain or loss. Accordingly, each such interest must be treated as a *separate* "property" for income tax purposes. Failure to treat each such separate interest as a separate property would disregard or unduly confuse the administration of the provisions of the Revenue Acts requiring the computation of gain or loss upon the sale of an asset and the provisions distinguishing between ordinary gain or loss and capital gain or loss, taxable at different rates, depending upon the length of time the asset was held.

Accordingly, the term "property" may be defined as *each separate interest* owned by the taxpayer in each separate tract or parcel of land.

Section 114(b)4 of the Revenue Act of 1934 provides in part as follows:

PERCENTAGE DEPLETION FOR COAL AND METAL MINES AND SULPHUR.—* * * A taxpayer making his *first return under this title* in respect of a *property* shall state whether he elects to have the depletion allowance *for such property* for the taxable year for which the return is made computed with or without regard to percentage depletion, and the depletion allowance in respect of such property for such year shall be computed according to the election thus made. If the taxpayer fails to make such statement in the return, the depletion allowance for such property for such year shall be computed without reference to percentage depletion. The method, determined as above, 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. [Italics supplied.]

Questions regarding the right of election arising out of the above-quoted section are purely incidental to the general principles governing the granting of depletion allowances, and such questions are controlled by the same general rules of construction. Accordingly, it is the opinion of this office that the term " property " possesses the same meaning for purposes of election that it possesses for purposes of the computation of the depletion allowance.

Since the discussion in the foregoing paragraphs sets forth the general views of this office with reference to the meaning of the term " property," the specific questions presented in the several examples (with the exception of Example VIII) will not be discussed in so far as they relate to this particular problem, but will be answered only.

Example I. In 1934 A owned a certain tract of mineral land, the east half of which he operated and the west half he had leased to B. A considered the entire tract to be one " property " and made one election on his 1934 return regarding the method of depletion desired. In computing statutory gross and net income from the " property," he combined his own sales with royalties received from B.

Question: (*a*) Did A have one " property " or two?

(*b*) Is his election binding for both " properties " (if it is ruled there are two)?

Answer: (*a*) A had two " properties."

(*b*) In his 1934 return A incorrectly treated the two " properties " as one. Despite the fact that his return was defective in this respect, it was his *first* return with respect to both " properties," and the election that he made therein is binding with respect to such " properties." (See G. C. M. 13627, C. B. XIII–2, 64 (1934), and G. C. M. 15790, C. B. XIV–2, 127 (1935).)

Example II. In 1934 A owned a certain tract of mineral land and operated a mine upon it, electing a certain method of depletion. In 1935 A leased the west half to B and made a new election with regard to depletion to be taken on the lease.

Question: Can A have only one " property " for the purpose of electing depletion, and two " properties " for the purposes of computing depletion?

Answer: A has two " properties " both for purposes of election and for purposes of depletion computation, and he is accordingly entitled to a new election with respect to each of these " properties."

Example III. The lease in Example I is legally terminated in any given year. A resumes full possession of the mineral tract under discussion.

Question: If it is held that there were two " properties " with two elections allowable in 1934, does the election which was made with respect to the lease continue as to that half of the tract of land? Does his election as made in 1934 for the east half become automatically applicable to the entire tract?

Answer: The termination of the lease operates to revest in A the full ownership of the tract in question, and his interest therein is a new " property " with respect to which he is entitled to a new election.

Example IV. Some time after Example III A grants a new lease to C on the south half of the tract in question.

Question: What new rights of election, if any, are allowable? What old rights of election, if any, are binding?

Answer: A is entitled to a new election not only with respect to his "property" in the south half of the tract but also with respect to his "property" in the north half.

Example V: In any given year A acquires from a single owner in a single deed three noncontiguous tracts of mineral land for a single consideration.

Question: For purposes of electing and computing depletion, did A acquire one "property" or three "properties"? Does a "property" require one continuous boundary?

Answer: A acquired three separate "properties." A "property" requires one continuous boundary.

Example VI: In any given year A simultaneously acquires two adjacent tracts of mineral land from two separate owners. Combined, they are operated as one mine by A.

Question: Is this one "property" or two in the hands of A for election and computation of depletion?

Answer: The interest owned by A in each of these tracts is a separate "property."

Example VII: Subsequently A sells all of the land he acquired in Example VI to B, the description in this deed being copied from the old records in which the two original tracts may be identified.

Question: How many "properties" does B have for depletion purposes?

Answer: Although A acquired the two adjacent tracts as two separate tracts under separate conveyances, B acquired the two tracts as one under one conveyance. His interest in this tract is only one "property."

Example VIII: A buys a tract of land containing a known ore body which he entirely mines out, having made an election for depletion in accordance with section 114. Subsequently he discovers an entirely separate ore body on the same tract which requires an entirely new and different system of operation.

Question: Can the new operation be construed to be a different "property" for the election of depletion?

Answer: As was noted in an earlier paragraph, article 23(m)–1(*j*) of Regulations 86 provides in part as follows:

> * * * 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.

Paragraph (*b*) of the same article defines a "mineral property" as 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.

Under the regulations, then, the taxpayer's interest in each separate "mineral property" within a single tract or parcel of land is a separate "property." It is provided, however, that he *may* treat such "properties" as one "property," if he consistently follows such a procedure. Accordingly, in the foregoing example, A is entitled to treat the separate ore body subsequently discovered as a different "property" and make a new election with respect thereto.

The conclusions reached herein under the Revenue Act of 1934 are also applicable under the corresponding provisions of the Revenue Acts of 1936 and 1938 and of the Internal Revenue Code.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

SECTION 115.—DISTRIBUTIONS BY CORPORATIONS.

SECTION 19.115–5: Distributions in liquidation. 1941–4–10573
I. T. 3445

INTERNAL REVENUE CODE AND REVENUE ACT OF 1938.

The original plan of liquidation adopted by the M Company on January —, 1938, provided for completion of its liquidation on or before December 31, 1940, which is one year short of the time which could have been adopted under section 115(c) of the Revenue Act of 1938. Held, the taxpayer may by amendment to the minutes covering the original plan extend the time for completion of the liquidation to December 31, 1941.

Advice is requested whether the M Company may extend the time set for the completion of its plan of liquidation, adopted in accordance with section 115(c) of the Revenue Act of 1938, under the circumstances herein set forth.

When the plan of liquidation of the M Company was adopted on January —, 1938, it was provided in the minutes that the liquidation was to be completed by December 31, 1940, which is one year short of the time which the company could have adopted under the provisions of section 115(c) of the Revenue Act of 1938. It now appears that the balance of the distributable assets of the company consists of cash, mortgage notes due over a period of several more years, and a plant site for which no immediate market exists. The question presented, therefore, is whether the company may by amendment to the minutes covering the original plan extend the final liquidation date to December 31, 1941, which would still be within the 3-year period specified in the statute, or whether the company is bound by the plan as originally adopted so that it would be necessary to complete liquidation by December 31, 1940.

It is the opinion of this office that, in accordance with the provisions of section 19.148–2 of Regulations 103, the company may amend the original plan of liquidation, provided it has complied with section 115(c) of the Internal Revenue Code.

Section 19.115–5(b) of Regulations 103 provides in part that—

* * * For this purpose the term "complete liquidation" includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, *not exceeding, from the close of the taxable year during which is made the first of the series of distributions under the plan, (1) three years if the first of such series of distributions is made in a taxable year beginning after December 31, 1937,* or (2) two years, if the first of such series of distributions was made in a taxable year beginning prior to January 1, 1938. [Italics supplied.]

Since the plan of liquidation was not adopted until 1938, it is held that a complete liquidation within the meaning of section 115(c) of the Internal Revenue Code will be effected, provided the plan is fully consummated on or before December 31, 1941.

The company must comply with the provisions of section 19.148-2 of Regulations 103, relating to the filing of information forms.

SECTION 116.—EXCLUSIONS FROM GROSS INCOME.

1941-13-10659
I. T. 3461

INTERNAL REVENUE CODE AND PRIOR REVENUE LAWS.

The term "coastwise," as used in G. C. M. 22383 (C. B. 1940-2, 227), the application of which is limited to cases involving wages earned by *seamen* while engaged in "coastwise" trade, relates to all vessels engaged in traffic between the various ports of the "United States," as that term is defined in section 3797(a)9 of the Internal Revenue Code and similar provisions of prior revenue laws.

Advice is requested as to the scope of the term "coastwise," as used in G. C. M. 22383 (C. B. 1940-2, 227), and, in particular, (*a*) whether it is limited to vessels plying between ports of continental United States only; (*b*) whether it applies to vessels sailing between continental United States and the Territories of Hawaii and Alaska; and (*c*) whether it applies to vessels sailing between continental United States and the *possessions* of the United States.

In G. C. M. 22383, supra, it was held that wages earned by any seaman (citizen or alien) while engaged in coastwise trade between American ports should be regarded as from sources within the United States. That opinion is limited in its application to the wages of seamen engaged in coastwise trade, and it is not applicable to passengers aboard ocean-going vessels. (See I. T. 3462, page 268, this Bulletin.)

It is held that the term "coastwise," as used in G. C. M. 22383, supra, the application of which is pertinent only in cases involving wages earned by seamen while engaged in "coastwise" trade, should be interpreted as relating to all vessels engaged in traffic between the various ports of the "United States," as that term is defined by section 3797(a)9 of the Internal Revenue Code and similar provisions of prior revenue laws. Section 3797(a)9 of the Internal Revenue Code reads as follows:

UNITED STATES.—The term "United States" when used in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia.

It follows that vessels engaged in traffic between ports of continental United States and ports of the Territories of the United States are engaged in "coastwise" trade, as that term is used in G. C. M. 22383, and that vessels engaged in trade between ports of continental United States and ports of the *possessions* of the United States, such as Puerto Rico and the Philippines, are not to be treated as engaged in "coastwise" trade.

1941–15–10673
I. T. 3467

INTERNAL REVENUE CODE AND REVENUE ACTS OF 1928, 1932, 1934, 1936, AND 1938.

Pursuant to authority contained in section 3791(b) of the Internal Revenue Code, G. C. M. 22383 (C. B. 1940–2, 227), relating to wages of seamen employed on vessels engaged in coastwise trade, will not be applied retroactively, but will be applied only to the taxable year 1940 and subsequent taxable years.

Advice is requested relative to the retroactive application of G. C. M. 22383 (C. B. 1940–2, 227), in which it was held that wages earned by any seaman (citizen or alien) while engaged in coastwise trade between American ports should be regarded as from sources within the United States.

In the inquiry presented, reference is made to G. C. M. 12167 (C. B. XII–2, 126 (1933)), in which it was held that the taxpayer, master of a steamship engaged in trade between certain United States ports, was a *bona fide* nonresident citizen of the United States for more than six months of the taxable year within the meaning of section 116(a) of the Revenue Act of 1928, by virtue of the fact that he was absent from the United States and its territorial waters for 234 days during the year in question. It is pointed out that in reliance upon the provisions of G. C. M. 12167, supra, which was revoked by G. C. M. 22383, supra, seamen employed on vessels engaged in coastwise trade considered their wages to be exempt from Federal income tax. Under such circumstances, the request is made that G. C. M. 22383, supra, be not applied to wages earned prior to the taxable year 1940 and during the time that G. C. M. 12167, supra, was in effect.

In view of the apparent hardship which will result if G. C. M. 22383, supra, is applied retroactively, it is the opinion of the Bureau that it should not be applied to taxable years prior to the taxable year 1940. Accordingly, pursuant to the authority contained in section 3791(b) of the Internal Revenue Code, G. C. M. 22383, supra, will not be applied retroactively, but will be applied only to the taxable year 1940 and subsequent taxable years.

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved March 25, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

1941–18–10700
I. T. 3472

INTERNAL REVENUE CODE.

A pension received in 1939 by A, who retired during that year, in which he was entitled to the benefits of section 116(a) of the Internal Revenue Code as a *bona fide* nonresident citizen of the United States for more than six months during the taxable year, and who, during the period of his employment, had rendered services both within and without the United States, represents taxable income to the extent that it is based upon services rendered within the United States. The entire amount of the pension, however, is taxable to A for all years with respect to which he may be classified as a resident of the United States.

Advice is requested with respect to the treatment for Federal income tax purposes of pension payments received by A, who retired during the year 1939, in which he was entitled to the benefits of section 116(a) of the Internal Revenue Code as a *bona fide* nonresident citizen of the United States for more than six months during the taxable year, and who, during the period of his employment, had rendered services both within and without the United States.

A, a citizen of the United States, began his service with the M Company in July, 1920, and continued to be actively employed by that company until September 30, 1939, at which time he was retired on a pension. From October 1, 1939, to December 31, 1939, he received pension payments aggregating x dollars. Of the 19 years covering the taxpayer's service, approximately 12 years were spent abroad in connection with his employer's foreign operations. During 1939, the taxpayer was in the United States from January 1 to April 1, returning to and remaining at his foreign post of duty the remainder of the year. He contends that the pension payments received in 1939 should be excluded from his taxable income for that year because of section 116(a) of the Internal Revenue Code, which provides in part as follows:

SEC. 116. EXCLUSIONS FROM GROSS INCOME.

In addition to the items specified in section 22(b), the following items shall not be included in gross income and shall be exempt from taxation under this chapter:

(a) EARNED INCOME FROM SOURCES WITHOUT UNITED STATES.—In the case of an individual citizen of the United States, a bona fide nonresident of the United States for more than six months during the taxable year, amounts received from sources without the United States * * * if such amounts would constitute earned income as defined in section 25(a) if received from sources within the United States; * * *

In Mim. 3283 (C. B. IV–1, 14 (1925)) it is stated that the term "earned income" means wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered by the taxpayer, and that retired pay and pensions which are taxable constitute "earned income." For the purpose of determining whether earned income is from sources within or without the United States, the place where the services are performed and not where the compensation is paid is the controlling factor. (See I. T. 2286, C. B. V–1, 52 (1926).)

In the instant case, the pension payments received by A in 1939 represent compensation for services rendered during his entire period of employment. That proportion which the number of years of his service rendered in the United States (7) bears to the entire period of service (19) constitutes that part of the pension which is taxable income. In other words, the pension is taxable to the extent that it is paid for services rendered in the United States.

In the case of a *resident* of the United States, however, earnings from all sources must be included in gross income unless excluded by a specific statutory exception to the general rule, such as section 116(h) of the Internal Revenue Code, relating to compensation of employees of foreign governments. This position is in harmony with the decision in *Julius B. B. Stryker* v. *Commissioner* (29 B. T. A., 1025). There the taxpayer, who was not a *bona fide* nonresident of the United States for more than six months during the taxable year 1928, received in that year commissions which were attributable to services

performed during the year 1927 with respect to which year he was a *bona fide* nonresident for more than six months. The Board of Tax Appeals held that the compensation received in 1928 for the services rendered in 1927 was not exempt from taxation.

In the light of the foregoing, it is held that for the taxable year 1939, during which A was a "bona fide nonresident of the United States for more than six months," the pension payments received by him represent taxable income to the extent that such payments are based upon services rendered within the United States. The taxpayer will, however, be required to return as taxable income the entire amount of the pension received in years as to which he may be classified as a resident of the United States.

INTERNAL REVENUE CODE.

Gain on sale of "National Defense Series" obligations. (See I. T. 3475, page 199.)

SECTION 117.—CAPITAL GAINS AND LOSSES.

SECTION 19.117–4: Determination of period for which capital assets are held. 1941–9–10619 I. T. 3453

INTERNAL REVENUE CODE.

> Where property was acquired by gift after December 31, 1920, the fair market value of the property at the time of the gift being lower than the basis of such property in the hands of the donor or the last preceding owner by whom it was not acquired by gift, and the property is sold or otherwise disposed of by the donee for an amount less than such fair market value, the donee will be considered as having held the property from the date of the gift for the purposes of section 117 of the Internal Revenue Code.

Advice is requested whether in determining, under section 117 of the Internal Revenue Code, the period for which property acquired by gift subsequent to December 31, 1920, was held, where the value of the property at the time of the gift is used for the purpose of determining loss in accordance with the provisions of section 113(a)2 of the Internal Revenue Code, such period should be computed from the date of the gift or whether there should be included the period prior thereto for which the property was held by the donor or the last preceding owner by whom it was not acquired by gift.

Section 113(a)2 of the Internal Revenue Code provides in part as follows:

> GIFTS AFTER DECEMBER 31, 1920.—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower. * * *

Section 117(h)2 of the Code provides:

> In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held

by any other person, if under the provisions of section 113, such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

It will be observed that under section 113(a)2 of the Code, supra, where the fair market value of property at the time of the gift must be used by the donee as the basis for determining the loss sustained from a sale or exchange thereof, the donee does not use the donor's basis of the property under section 113 of the Code, either in whole or in part, and hence, in determining the period for which the property was held by the donee, the period for which such property was held by the donor or "such other person" should not be included.

It is, accordingly, held that where property was acquired by gift after December 31, 1920, the fair market value of the property at the time of the gift being lower than the basis of such property in the hands of the donor or the last preceding owner by whom it was not acquired by gift, and the property is sold or otherwise disposed of by the donee for an amount less than such fair market value at the time of the gift, the donee will be considered as having held the property from the date of the gift for the purposes of section 117 of the Internal Revenue Code.

SECTION 124.—AMORTIZATION DEDUCTION.

SECTION 19.124–1: Definitions. 1941–23–10741
(Also Section 19.124–9.) T. D. 5049

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 19.—INCOME TAX.

Regulations 103, as amended by Treasury Decision 5016 [C. B. 1940–2, 119], amended to conform to Public Law 3 (Seventy-seventh Congress), extending time for certification of national-defense facilities and contracts for amortization purposes.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

In order to conform Regulations 103 [Part 19, Title 26, Code of Federal Regulations, 1940 Sup.], as amended by Treasury Decision 5016, approved October 23, 1940 (C. B. 1940–2, 119), to the provisions of Public Law 3 (Seventy-seventh Congress), approved January 31, 1941, extending the time for certification of national-defense facilities and contracts for amortization purposes, such regulations are amended as follows:

PARAGRAPH 1. The following is inserted immediately preceding section 19.124–1:

PUBLIC LAW 3, APPROVED JANUARY 31, 1941.

Resolved by the Senate and House of Representatives of the United States of America in Congress assembled, That section 124(f)(1) of the Internal Revenue Code is amended by striking out ", within the time specified in paragraph (3) of this subsection, and."

SEC. 2. Section 124(f)(3) of the Internal Revenue Code is amended to read as follows:

"The certificate provided for in paragraph (1) shall have no effect unless an application therefor is filed before the expiration of sixty days after the beginning of such construction, reconstruction, erection, or installation or the date of such acquisition, or before February 6, 1941, whichever is later: *Provided*, That in no event and notwithstanding any of the other provisions of this section, no amortization deduction shall be allowed in respect of any emergency facility for any taxable year unless a certificate in respect thereof under paragraph (1) of this subsection shall have been made prior to the making of the election, pursuant to subsection (b) and (d)(4) of this section, to take the amortization deduction and begin the sixty-month period in or with such taxable year, or before February 6, 1941, whichever is later."

SEC. 3. Section 124(i) of the Internal Revenue Code is amended—

(a) By striking out from the first sentence thereof ", before the expiration of ninety days after the making of such contract or one hundred and twenty days after the date of the enactment of the Second Revenue Act of 1940, whichever of such periods expires the later,";

(b) By striking out from the second sentence thereof ", before the expiration of ninety days after the making of a contract or one hundred and twenty days after the date of the enactment of the Second Revenue Act of 1940, whichever of such periods expires the later,"; and

(c) By adding after the second sentence thereof a new sentence to read as follows: "The certificates provided for under this subsection shall have no effect unless an application therefor is filed before the expiration of sixty days after the making of such contract, or before February 6, 1941, whichever is later."

SEC. 4. The amendments made by this joint resolution to section 124 of the Internal Revenue Code shall be applicable as if they were a part of such section on the date of the enactment of the Second Revenue Act of 1940.

PAR. 2. Section 19.124–1(c) is amended to read as follows:

(c) "*Emergency facility*" means any facility, land, building, machinery, or equipment, or any part thereof,—

(1) the acquisition of which occurred after June 10, 1940, or the construction, reconstruction, erection, or installation of which was completed after such date, and

(2) any part of the construction, reconstruction, erection, installation, or acquisition of which has been certified by the Advisory Commission and the Secretary of the department concerned as necessary in the interest of national defense during the emergency period (such certificate to have no effect unless an application therefore is filed (A) before the expiration of 60 days after the beginning of such construction, reconstruction, erection, or installation, or the date of such acquisition, or (B) before February 6, 1941, whichever date is the later).

The term "emergency facility," as so defined, may include, among other things, improvements of land, such as the construction of airports and the dredging of channels.

PAR. 3. Section 19.124–9 is amended to read as follows:

SEC. 19.124–9. *Reimbursement by United States for cost of facility.*—If the taxpayer has been or will be reimbursed by the United States for all or a part of the cost of any emergency facility pursuant to any contract with the United States, no amortization deductions will be allowed with respect to such facility for any month after the end of the month in which such contract is made, unless the Advisory Commission and the Secretary of the department concerned have certified to the Commissioner that the contract contains provisions adequately protecting the United States with reference to the future use and disposition of such facility. For treatment of reimbursements, see section 19.124–6. If the Advisory Commission and the Secretary of the department concerned have certified to the Commissioner that under such contract no

reimbursement is provided for within the meaning of section 124(i), such certificate shall be conclusive of such fact. The certificates referred to in this section shall have no effect unless an application therefor is filed (1) before the expiration of 60 days after the making of such a contract, or (2) before February 6, 1941, whichever date is the later.

(This Treasury decision is issued under the authority contained in sections 1 to 4, inclusive, of Public Law 3 (Seventy-seventh Congress) and section 62 of the Internal Revenue Code, 53 Stat., 32 (26 U. S. C., Sup. V, 62).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved May 29, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register June 3, 1941, 9.58 a. m.)

SECTION 19.124–9: Reimbursement by United States for cost of facility.

INTERNAL REVENUE CODE.

Regulations 103, amended. (See T. D. 5049, page 255.)

SUPPLEMENT C.—CREDITS AGAINST TAX.

SECTION 131.—TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF UNITED STATES.

SECTION 19.131–1: Analysis of credit for taxes. 1941–14–10666
I. T. 3464

INTERNAL REVENUE CODE.

The 2 per cent national defense tax levied by Canada under Part XV of the Income War Tax Act enacted at the first session, Nineteenth Parliament, 4 George VI, 1940, is an income tax and is allowable as a credit against the Federal income tax of a citizen of the United States under the provisions of section 131(a)1 of the Internal Revenue Code, as amended, subject to the limitations contained in section 131(b), as amended.

Advice is requested whether the 2 per cent national defense tax levied by Canada on the total net income of residents, including citizens of the United States, is allowable as a credit against the Federal income tax of a citizen of the United States under section 131(a) of the Internal Revenue Code, as amended, relating to credits for income, war profits, and excess profits taxes paid or accrued to foreign countries.

It is provided in Part XV of the Income War Tax Act, as enacted at the first session, Nineteenth Parliament, 4 George VI, 1940, that in addition to any other tax imposed by the act there shall be levied and paid upon the total income of persons liable to income tax, with

the exception of certain officers and employees of the Government of Canada, a tax to be known as the national defense tax at the rate—

(*a*) in the case of a married person, of 2 per centum if the income exceeds $1,200 per year; and in the case of a husband and wife having each a separate income, of 2 per centum if the income of each is in excess of $600 per year;

(*b*) in the case of a single person, of 2 per centum if the income exceeds $600 per year and does not exceed $1,200 per year; or of 3 per centum if the income exceeds $1,200 per year * * *.

As the Canadian national defense tax in question is levied upon income, it is an income tax within the meaning of section 131(a)1 of the Internal Revenue Code, as amended, and is allowable as a credit against Federal income tax in the case of a citizen of the United States. However, the amount of the credit allowable is subject to the limitations contained in section 131(b), as amended.

SUPPLEMENT D.—RETURNS AND PAYMENT OF TAX.

SECTION 143.—WITHHOLDING OF TAX AT SOURCE.

SECTION 19.143–1: Withholding tax at source. 1941–6–10590
(Also Section 144, Section 19.144–1.) I. T. 3449

INTERNAL REVENUE CODE.

The obligation of corporations and paying agents to withhold tax from interest, dividends, and like items under the provisions of sections 143 and 144 of the Internal Revenue Code and those sections as amended by the Revenue Act of 1940 is unaffected by the decree of May 24, 1940, of the Royal Netherlands Government now exercising its functions in London, England, vesting technical title to the property involved in that Government.

Tax should also be withheld under the foregoing provisions of law from the income on seized enemy property in the hands of the alien property custodians of the British Government.

Advice is requested as to the possible effect of a decree of the Royal Netherlands Government, temporarily residing and exercising its functions in London, England, dated May 24, 1940, on the obligation of corporations and paying agents under sections 143 and 144 of the Internal Revenue Code to withhold tax on interest, dividends, and like items, paid or credited to a nonresident alien.

Advice is also requested whether securities which have been seized by the British Alien Property Custodian, presumably the property of Germans or nationals of other countries at war with Great Britain, should be considered as the property of the British Government, or should be treated as held in custody for the former owners and tax withheld on the income derived from such securities.

The Government of the United States continues to recognize the Royal Netherlands Government temporarily residing in London, England, and the Department of State has taken official cognizance of the decree of May 24, 1940.

The decree in question provides in part as follows:

ARTICLE 1.

1. Title to claims against persons, partnerships, companies, corporations, firms, institutions and public bodies, which claims belong to natural or legal persons domiciled in the Kingdom of the Netherlands, as well as to all claims of the aforesaid persons for the delivery of gold deposited, in so far as these claims are in any form whatsoever capable of being encumbered, pledged, transferred or sold or the like, outside of the realm in Europe, is hereby vested in the State of the Netherlands, as represented by the Royal Netherlands Government, temporarily resident in London and exercising its functions there, subject always to the provisions of article 5.

2. The foregoing is also applicable to all claims resulting from confirmed credits, participation in the capital of and loans to companies, corporations and firms (regardless of whether these claims are evidenced by stock certificates, bonds or other securities or commercial paper) in so far as the aforementioned claims belong to natural or legal persons within the Kingdom of the Netherlands and, in so far as these claims are in any form whatsoever capable of being encumbered, pledged, transferred or sold, or the like, outside of the realm in Europe.

3. The proprietary rights vested in the State of the Netherlands, by virtue of the provisions of the preceding paragraphs, shall only be exercised for the conservation of the rights of the former owners.

* * * * * * *

ARTICLE 5.

1. Three months after the present emergency conditions shall in our judgment have ceased to exist, restitution shall be made of the claims mentioned in article 1 to the former owners.

2. In deviation from the provisions in the previous paragraph our Ministers of Justice and of Colonies are jointly empowered to make restitution in advance of the time mentioned in the previous paragraph to the former owners, provided it be proven to their satisfaction that direct or indirect use of these claims in behalf of the enemy is excluded.

It will be observed from the quoted provisions and other terms of the decree that while technical title to the property involved has been transferred to the Netherlands Government, the rights thus vested in that Government are to be exercised only for the conservation of the rights of the former owners. Under certain conditions the property rights may be fully restored to the former owners prior to the cessation of the present emergency. The basic reason for the decree is to prevent the property involved from being applied against the interest of the Netherlands, and to that end such property is "entrusted" in the Government of the Netherlands.

It is the view of this office that the beneficial ownership of the property in question remains in the former owners; that the decree contemplates that technical title also will ultimately be restored to such owners; and that in the meantime the Netherlands Government is merely holding the property for the benefit of such owners.

Accordingly, the obligation of corporations and paying agents in the United States to withhold tax from interest, dividends, and like items, under the provisions of sections 143 and 144 of the Internal Revenue Code and those sections as amended by the Revenue Act of 1940, is unaffected by the promulgation of the Netherlands decree of May 24, 1940.

With respect to property in the hands of the British alien property custodians, the British Trading with the Enemy Act, 1939 (2 and 3 Geo. 6, Ch. 89), contains provisions relating to the prevention of the payment of money to an enemy, and for the preservation of

enemy property in contemplation of arrangements to be made at the conclusion of peace. (Paragraph 7, 1.) It does not appear from that Act that consideration has been given to the disposition of any income which might become due and payable upon the property while it is in the custody of the British alien property custodians. There is nothing to indicate that the British Government holds itself out to be the owner of the seized property. For that reason this office is of the opinion that the British Government should be considered, for income tax purposes, the custodian and not the owner of the property which has come into the possession of the alien property custodians.

The tax should, therefore, be withheld from the income on such property in the custody of the British Government, in accordance with the provisions of sections 143 and 144 of the Internal Revenue Code and those sections as amended by the Revenue Act of 1940.

SECTION 19.143–1: Withholding tax at source. 1941–19–10713
(Also Section 19.143–7; Section 144, Sections T. D. 5046
19.144–1, 19.144–2; Section 262, Section 19.262–4.)

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PARTS 14 AND 19.—INCOME TAX.

Withholding under sections 143 and 144 of the Internal Revenue Code, as amended by the Revenue Act of 1940—Regulations 103 amended—Treasury Decision 4883 [C. B. 1939–1 (Part 1), 147] revoked.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

PARAGRAPH 1. The Canadian Government has advised the Government of the United States that, effective April 30, 1941, the rate of 5 per cent income tax theretofore imposed upon income derived from sources within Canada by nonresidents thereof, including United States residents, has been increased to 15 per cent and that the Government of the United States as of such date is released from the obligations of the reciprocal tax convention between the United States and Canada which was ratified August 13, 1937. In conformity thereto, Regulations 103 [Part 19, Title 26, Code of Federal Regulations, 1940 Sup.] are amended as follows:

(A) Section 19.143–1, as amended by Treasury Decision 4979, approved July 1, 1940 [C. B. 1940–2, 138] is further amended as follows:

(*a*) By adding immediately preceding the last sentence of the first paragraph thereof the following:

Such reduced rate is, however, not applicable to income paid on or after April 30, 1941.

(*b*) By inserting in paragraph (*c*) after "Canada" the words "prior to April 30, 1941."

(B) Section 19.143–7, as amended by Treasury Decision 4979, is further amended by striking out the third sentence of the second paragraph thereof and substituting therefor the following sentence:

Every United States withholding agent shall make and file with the collector, in duplicate, an information return on Form 1042B, for the calendar year 1939, the calendar year 1940, and for the period January 1, 1941, to April 29, 1941, both dates inclusive, in addition to the withholding return on Form 1042 with respect to the items of income from which a tax of only 5 per cent was withheld from Canadian addressees.

(C) Section 19.144–1, as amended by Treasury Decision 4979, is further amended—

(*a*) by inserting in the third paragraph thereof after "(See paragraph 106 of the Appendix to these Regulations.)":

On or after April 30, 1941, no such treaty is in effect.

(*b*) by striking out the last paragraph thereof and substituting therefor the following paragraph:

With respect to income paid on or after June 26, 1940, and prior to January 1, 1945, the rate of withholding (except with respect to dividends paid prior to April 30, 1941, to corporations organized under the laws of Canada and dividends paid to corporations or other entities created or organized under the laws of Sweden) is 16½ per cent instead of 15 per cent.

(D) Section 19.144–2, as amended by Treasury Decision 4979, is further amended—

(*a*) by striking out footnote 2 in the second table appearing therein and substituting therefor:

2. In the case of dividends paid to a corporation organized under the laws of Canada, the rate is 5 per cent with respect to dividends paid prior to April 30, 1941.

(*b*) By adding below footnote 4 in the second table appearing therein the following:

NOTE.—The rate of 5 per cent appearing in line 5 is applicable only with respect to income paid prior to April 30, 1941. Income paid on or after such date is subject to withholding at the rate of 16½ per cent.

(E) Section 19.262–4, as amended by Treasury Decision 4979, is further amended by striking out the last paragraph thereof and substituting therefor the following paragraph:

With respect to income paid on or after June 26, 1940, and prior to January 1, 1945, the rate of withholding (except with respect to dividends paid prior to April 30, 1941, to residents of, or corporations organized under the laws of, Canada or dividends paid to residents of, or to corporations or other entities created or organized under the laws of, Sweden) is 16½ per cent instead of 15 per cent.

PAR. 2. By virtue of the amendments made by this Treasury decision, fixed or determinable annual or periodical income paid on or after April 30, 1941, to nonresident alien individuals, residents of Canada, or to corporations organized under the laws of Canada is subject to the rates of withholding at the source applicable generally to nonresident aliens and foreign corporations. See section 19.144–2, Regulations 103, as amended by Treasury Decision 4979, approved July 1, 1940.

In the case of income paid subsequent to April 29, 1941, and prior to May 15, 1941, the withholding of the tax in the case of nonresident alien individuals, residents of Canada, or corporations organized under the laws of Canada at the rates applicable under Regulations 103 prior to their amendment by this Treasury decision shall

be considered as sufficient compliance with the provisions of law and regulations relating to withholding of the tax at the source.

PAR. 3. Treasury Decision 4883, approved January 16, 1939 [Part 14, Title 26, Code of Federal Regulations, 1939 Sup.], and that Treasury decision as made applicable to the Internal Revenue Code by Treasury Decision 4885, approved February 11, 1939 [C. B. 1939-1 (Part 1), 396] [Part 465, Subpart B, of such Title 26, 1939 Sup.] are revoked effective April 30, 1941, in so far as concerns income paid on or after such latter date to persons whose addresses are in Canada.

(This Treasury decision is issued under the authority contained in section 62 of the Internal Revenue Code (53 Stat., 32, 26 U. S. C., Sup. V, 62) and the reciprocal tax convention between the United States and Canada (50 Stat., 1399).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved May 8, 1941,

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register May 9, 1941, 2 p. m.)

SECTION 19.143-3: Exemption from withholding. 1941-23-10731
I. T. 3480

INTERNAL REVENUE CODE.

No withholding is required with respect to annuity income payable to French citizens residing in France. However, withholding is required with respect to such income payable to citizens of France temporarily in the United States who are nonresident aliens. The tax convention and protocol between United States and France is still in effect.

Advice is requested whether the convention and protocol on double taxation between the United States and the Republic of France, effective January 1, 1936, is still in force and effect, and whether annuity income payable to French citizens is exempt from the withholding provisions of section 143 of the Internal Revenue Code.

Article X of the convention on double taxation between the United States and France provides that the agreement shall become effective on the 1st day of January following the exchange of ratifications and shall remain effective for a period of 5 years, and thereafter until 12 months from the date on which either contracting party gives notice of its termination.

The convention was proclaimed by the President of the United States on April 16, 1935, and became effective January 1, 1936. The steps contemplated by Article X as essential to the termination of the convention have not been taken by either contracting party and the convention is still in full force and effect.

Under Article IX of the convention, life annuities paid in one of the contracting States to a citizen of the other State residing

there are exempt from tax in the former State. It was held in G. C. M. 21187 (C. B. 1939–1 (Part 1), 141) that an annuity paid by a domestic insurance company periodically during life, or a specified number of years, under an obligation contained in an insurance contract constituted an annuity within the meaning of Article IX(*c*) of the convention.

Article 3(*b*) of Part II of Treasury Decision 4880 (C. B. 1939–1 (Part 1), 85) provides that the exemption applying to items of income specifically enumerated in Article IX of the convention shall not extend to French citizens residing elsewhere than in France nor to individuals residing in France who are not citizens of France.

Accordingly, withholding is not required with respect to annuity payments made to citizens of France residing in France, but is required with respect to such payments made to citizens of France temporarily residing in the United States who are nonresident aliens.

It is to be noted that under Executive Order No. 8389, as amended, the transfer of funds from the United States to persons in France is restricted. (See Mim. 5075, C. B. 1940–2, 141.)

SECTION 19.143–7: Return and payment of tax withheld.

INTERNAL REVENUE CODE.

Regulations 103, amended. (See T. D. 5046, page 260.)

SECTION 144.—PAYMENT OF CORPORATION INCOME TAX AT SOURCE.

SECTION 19.144–1: Withholding in the case of nonresident foreign corporations.

INTERNAL REVENUE CODE.

Interest, dividends, and like items arising from property involved in the decree of the Royal Netherlands Government and property in the custody of the alien property custodians of Great Britain. (See I. T. 3449, page 258.)

SECTION 19.144–1: Withholding in the case of nonresident foreign corporations.

INTERNAL REVENUE CODE.

Regulations 103, amended. (See T. D. 5046, page 260.)

SECTION 19.144–2: Aids to withholding agents in determining liability for withholding of tax.

INTERNAL REVENUE CODE.

Regulations 103, amended. (See T. D. 5046, page 260.)

SECTION 203(a).—NET INCOME OF LIFE INSURANCE COMPANIES: GENERAL RULE.

SECTION 19.203(a)(2)-1: Reserve funds. . 1941-3-10566
I. T. 3443

INTERNAL REVENUE CODE.

Where during its taxable year a large part of the life insurance in force with the M Life Insurance Co. and the reserves thereon were assumed by the N Life Insurance Co., the taxpayer (the M Life Insurance Co.) must use an average of its reserve funds required by law at the beginning and end of its taxable year in determining the percentage of the mean reserve deductible under section 203(a)2 of the Internal Revenue Code. The use of the arithmetical mean of the reserve funds at the beginning of the year and the end of each month thereafter is not permissible.

Advice is requested whether the M Life Insurance Co. (the taxpayer) must use an average of its reserve funds required by law at the beginning and end of its taxable year in determining the percentage of the mean reserve deductible under section 203(a)2 of the Internal Revenue Code, or whether in making such determination the use of the arithmetical mean of the reserve funds at the beginning of its taxable year and the end of each month thereafter is permissible.

Effective August —, 1940, a large part of the life insurance in force with the M Life Insurance Co. (the taxpayer) and the reserves thereon were assumed by the N Life Insurance Co. The taxpayer states that due to the reinsurance during the year a deduction of a certain percentage of the mean of the reserve funds held at the beginning and the end of the taxable year 1940 will not be on the same basis as that on which its gross income is reported, since such computation will not reflect an increase in the reserve funds for the period January 1 to August —, 1940. The taxpayer desires to use the arithmetical mean of the reserve funds at the beginning of the year and the end of each month during the year 1940 instead of the mean of the reserve funds at the beginning and end of the year.

Section 203(a)2 of the Internal Revenue Code provides in part as follows:

SEC. 203. NET INCOME OF LIFE INSURANCE COMPANIES.

(a) GENERAL RULE.—In the case of a life insurance company the term "net income" means the gross income less—

* * * * * * *

(2) RESERVE FUNDS.—An amount equal to 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that in the case of any such reserve fund which is computed at a lower interest assumption rate, the rate of 3¾ per centum shall be substituted for 4 per centum. * * *

In *Western & Southern Life Insurance Co.* v. *Huwe*, decided by the United States District Court for the Southern District of Ohio, Western Division, on August 14, 1939 (unreported), involving a similar issue, the court said:

The language employed by Congress in the section under consideration [section 245(a)2 of the Revenue Act of 1926] is clear and unambiguous. It specif-

ically provides that the deduction granted shall be measured by the mean of the reserve funds of a life insurance company required by law which are held at the beginning and end of the taxable year—not at some other periods.

The word "mean" * * * is defined in Webster's New International Dictionary (1933) as follows: *Math.* Average; having an intermediate value between two extremes, or between the several successive values of a variable quantity during one cycle of variation such that, were they all equal, the mean would be their common value; as, mean distance; mean motion; mean solar day.

* * * * * * *

The court is of opinion that under the statute only those reserves held by plaintiff at January 1, 1927, and December 31, 1927, could be included, in the determination of the mean of plaintiff's "reserve funds required by law and held at the beginning and end of the taxable year" 1927.

(Section 245(a)2 of the Revenue Act of 1926 corresponds to section 203(a)2 of the Internal Revenue Code.)

The computation of the mean reserve was also involved in *Great Southern Life Insurance Co.* v. *Commissioner* (89 Fed. (2d), 54, certiorari denied, 302 U. S., 698). In that case a large increase in the reserves of the taxpayer occurred during the taxable year under consideration due to reinsurance and acquisition by purchase agreements of all of the outstanding policies of other life insurance companies. The Bureau took the position that the taxpayer was entitled to a deduction based on the reserves at the beginning and end of the taxable year, and that neither the reserves at the beginning of the year of the companies whose policies were acquired nor the reserves of such companies at the date of assignment of the policies could be taken into consideration in the computation of the "mean" reserve. The Bureau's position was sustained by the United States Board of Tax Appeals (*Great Southern Life Insurance Co.* v. *Commissioner*, 33 B. T. A., 512), and the decision of the Board was affirmed by the United States Circuit Court of Appeals for the Fifth Circuit (cited supra).

In the light of the foregoing, it is held that the M Life Insurance Co. must use an average of its reserve funds required by law at the beginning and end of its taxable year in determining the percentage of the mean reserve deductible under section 203(a)2 of the Internal Revenue Code. The use of the arithmetical mean of the reserve funds at the beginning of the year and the end of each month thereafter is not permissible.

SECTION 204(b).—INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL: DEFINITION OF INCOME, ETC.

SECTION 19.204(b)-1: Gross income of insurance companies other than life or mutual. 1941-5-10578 G. C. M. 22503

REVENUE ACT OF 1921, SUBSEQUENT REVENUE ACTS, AND INTERNAL REVENUE CODE.

An insurance company, other than life or mutual, is entitled in computing the "premium earned," as used in section 246(b)5 of the Revenue Act of 1921, corresponding provisions of subsequent Revenue Acts, and the Internal Revenue Code, to exclude therefrom the net addition made during the taxable year to the additional reserve for noncancelable health and accident policies required

An opinion is requested whether G. C. M. 18975 (C. B. 1937–2, 355) should be followed, in view of the decision in *Massachusetts Protective Association, Inc.*, v. *United States* (114 Fed. (2d), 304).

In G. C. M. 18975, supra, it was held that in the case of an insurance company, other than life or mutual, an amount set aside pursuant to instructions from the insurance department of a State to cover its estimated future liability on noncancelable health and accident policies is not deductible under the provisions of the Revenue Act of 1921 and subsequent Revenue Acts. The position was there taken that the term "unearned premiums," as used in section 246(b)5 of the Revenue Act of 1926, means advance premiums collected which the company has not yet had time to earn, and it was held, in effect, that such term does not include amounts set aside to cover the company's estimated future liability on noncancelable health and accident policies.

In *Massachusetts Protective Association, Inc.*, v. *United States*, supra, it was held that the taxpayer was entitled in computing its "premiums earned" for the year 1926, under section 246(b)5 of the Revenue Act of 1926, to exclude therefrom the net addition made during that year to the additional reserve for noncancelable health and accident policies required by State laws, or, in other words, that this addition to the reserve fund was a part of "unearned premiums" within the meaning of the Revenue Act. The court stated in part as follows:

> As long as these reserve funds must be held to provide for expected insurance liabilities in the future on these noncancelable health and accident policies and are not to be used for the general purposes of the company, they are not "earned premiums" within the meaning of Congress and not includible in gross income. The test is not whether the part of the premium set aside in the reserve for noncancelable health and accident insurance "belongs" to the company in the event of cancellation or lapsing of the policy, but whether that amount is such a part of the company's gross income as Congress considered should be treated as net income for the purposes of taxation. (*McCoach* v. *Insurance Co. of North America*, supra.) We hold that it is not.

Since G. C. M. 18975, supra, is inconsistent with the decision in the Massachusetts Protective Association, Inc., case, it is hereby revoked. However, the application of that court decision should be limited to cases involving noncancelable health and accident insurance.

This ruling applies to such cases arising under the Revenue Act of 1921, subsequent Revenue Acts, and the Internal Revenue Code.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

SUPPLEMENT H.—NONRESIDENT ALIEN INDIVIDUALS.

SECTION 211.—TAX ON NONRESIDENT ALIEN INDIVIDUALS.

SECTION 19.211–7: Taxation of nonresident alien individuals. 1941–22–10725 I. T. 3478

INTERNAL REVENUE CODE.

A, a citizen of the country of R, who is employed in New York City by the purchasing commission of that country, is a nonresident alien individual engaged in a trade or business in the United States even though his salary is exempt from the Federal income tax.

Advice is requested as to the Federal income tax liability of A, a citizen of the country of R and a salaried executive of the Country of R Purchasing Commission in New York, under the circumstances herein set forth.

A, who is a citizen of the country of R, entered the United States in September, 1939, accompanied by his wife and son, on temporary visa. Due to war conditions they remained in the United States, their visitors' permits being renewed from time to time. In November, 1940, A accepted an appointment with the Country of R Purchasing Commission in New York City, an organization created by the Government of the country of R. A's gross income for 1940, exclusive of the compensation received by him for services performed as an employee of the Country of R Purchasing Commission, consisted of dividends and interest from securities of which he is the owner and the M Trust Co. of New York the custodian.

A's status, by virtue of his performance of personal services within the United States during the year 1940 as a member of the Country of R Purchasing Commission, is held to be that of a nonresident alien engaged in trade or business within the United States (section 211(b) of the Internal Revenue Code and section 19.211–7(*c*) of Regulations 103), even though the salary received for such services is exempt from the Federal income tax under section 116(h) of the Internal Revenue Code as compensation of an employee of a foreign government.

Form 1040B is the form of return required to be filed by A for the year 1940. In computing his Federal income tax liability on this return, he is entitled, in accordance with the provisions of section 213 of the Code, to the statutory deductions from total gross income from sources within the United States provided by section 23 of the Code, as amended. Under section 214 of the Code, as amended, A is entitled to a personal exemption of only $800 for the year 1940 notwithstanding the fact that he was married and living with his wife. He is not entitled to a credit for his dependent son even though the son received his chief support from him for the year 1940. (Section 214 of the Code and section 19.214–1 of Regulations 103.) The rates of tax applicable are the normal tax at 4 per cent imposed by section 11 of the Code, and the graduated surtax imposed by section 12(b) of the Code, as amended, if his surtax net income exceeded $4,000. In addition, he is liable to the 10 per cent defense tax (10 per cent of the amount representing the total of the normal tax and the surtax) imposed by section 15 of the Code, which was added by section 201 of the Revenue Act of 1940.

SECTION 212.—GROSS INCOME.

SECTION 19.212–2: Exclusion of earnings of foreign ships from gross income. (Also Section 19.231–3.) — 1941–1–10550, I. T. 3439

SECTION 19.212–2: Exclusion of earnings of foreign ships from gross income. (Also Section 231, Section 231–3.) 1941–15–10674 I. T. 3465

INTERNAL REVENUE CODE.

Panama satisfies the equivalent exemption provisions of sections 212(b) and 231(d) of the Internal Revenue Code and the Revenue Acts of 1936 and 1938.

SUPPLEMENT I.—FOREIGN CORPORATIONS.

SECTION 231.—TAX ON FOREIGN CORPORATIONS.

SECTION 19.231–3: Exclusion of earnings of foreign ships from gross income.

INTERNAL REVENUE CODE.

Fiji, equivalent exemption provisions of sections 212(b) and 231(d) of the Internal Revenue Code. (See I. T. 3439, page 267.)

SECTION 19.231–3: Exclusion of earnings of foreign ships from gross income.

INTERNAL REVENUE CODE.

Panama, equivalent exemption provisions of sections 212(b) and 231(d) of the Internal Revenue Code. (See I. T. 3465, above.)

SUPPLEMENT J.—POSSESSIONS OF THE UNITED STATES.

SECTION 251.—INCOME FROM SOURCES WITHIN POSSESSIONS OF UNITED STATES.

SECTION 19.251–1: Citizens of the United States and domestic corporations deriving income from sources within a possession of the United States. 1941–13–10660 I. T. 3462

INTERNAL REVENUE CODE.

Application of section 251 of the Internal Revenue Code to the compensation accruing to a taxpayer traveling from continental United States to the Philippine Islands.

Advice is requested as to the application of section 251 of the Internal Revenue Code to the compensation accruing to a taxpayer traveling from continental United States to the Philippine Islands under the circumstances hereinafter described.

A, a citizen of the United States in the service of the United States Government, is ordered to the Philippine Islands for duty there. He

leaves New York City on a Government transport and, in the course of the voyage, the vessel stops at the Panama Canal, San Francisco, Honolulu, and Guam. The entire trip lasts from 40 to 45 days. The question presented is how much, if any, of A's salary which accrues to him while he is en route to the Philippines is to be regarded as income from sources within the United States.

Section 251 of the Internal Revenue Code reads in part as follows:

(a) GENERAL RULE.—In the case of citizens of the United States or domestic corporations, satisfying the following conditions, gross income means only gross income from sources within the United States—

(1) If 80 per centum or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section), for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

* * * * *

(3) If, in the case of such citizen, 50 per centum or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another.

(b) AMOUNTS RECEIVED IN UNITED STATES.—Notwithstanding the provisions of subsection (a) there shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.

Section 3797(a)9 of the Internal Revenue Code reads as follows:

UNITED STATES.—The term "United States" when used in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia.

G. C. M. 22383 (C. B. 1940–2, 227), which has been cited in connection with the present inquiry and which holds that wages earned by any seaman (citizen or alien) while engaged in coastwise trade between American ports should be regarded as from sources within the United States, is limited in its application to the wages of *seamen* while engaged in coastwise trade, and it is not applicable to passengers aboard ocean-going vessels.

For the purposes of section 251(b) of the Internal Revenue Code, supra, it is held that such compensation as accrues to A, a passenger and the taxpayer in the instant case, after leaving New York City should *not* be regarded as income received in the United States, provided no stop-over is made at San Francisco or Honolulu, both of which are in the "United States," as that term is defined by section 3797(a)9 of the Internal Revenue Code, supra. In the event that such stop-over or stop-overs are made, the location of the last stop-over which occurs in continental United States or in the Territories of the United States would constitute the point of departure from the United States, and compensation accruing to the taxpayer thereafter should not be considered as income received in the United States. A taxpayer should not be deemed to have made a stop-over, as that term is used herein, merely by virtue of the fact that his ship stops for a day or two at another port within continental United States or the Territories.

SUPPLEMENT K.—CHINA TRADE ACT CORPORATIONS.

SECTION 262.—CREDIT AGAINST NET INCOME.

SECTION 19.262-2: Credits allowed China Trade Act corporations. 1941-20-10717 I. T. 3477

INTERNAL REVENUE CODE.

The special dividend credit provided by section 262 of the Internal Revenue Code will be allowed to corporations organized under the China Trade Act (1922) which have merely credited such dividends on their books to the accounts of shareholders within the time required by law for distribution of such dividends in order to obtain the special dividend credit, where, under the certification of the Secretary of Commerce, it is shown that such dividends are unqualifiedly subject to the demand of the shareholders.

Advice is requested whether corporations organized under the China Trade Act (1922) are entitled to the special dividend credit provided by section 262(b) of the Internal Revenue Code merely by crediting such dividends to stockholders' accounts on the corporation's books.

Section 19.262-3 of Regulations 103, interpreting section 262 of the Internal Revenue Code, defines the term "special dividend" as the amount which during the year ending on March 15 succeeding the close of the corporation's taxable year is distributed as a special dividend to or for the benefit of such persons as on the last day of the taxable year were resident in China, the United States, or possessions of the United States, or were individual citizens of the United States or China, and owned shares of stock of the corporation.

The items of gross income to be included in the return of a corporation organized under the China Trade Act and the deductions allowable are the same as in the case of other domestic corporations. (Section 19.262-1, Regulations 103.)

With respect to the dividends paid credit allowed domestic corporations under section 27(b) of the Internal Revenue Code, the Bureau considers a dividend as paid when it is received by the shareholder. (See section 19.27(b)-2, Regulations 103.) Section 19.27(b)-2 also provides that where 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. In the case of *Saenger* v. *Commissioner* (84 Fed. (2d), 23, Ct. D. 1186, C. B. 1937-1, 206) the court emphasized the Bureau's position that such crediting will constitute payment where the dividends are unqualifiedly made subject to the demand of the shareholders.

Section 262(b)1 of the Internal Revenue Code provides that the special dividend credit shall not be allowed China Trade Act corporations unless the Secretary of Commerce has certified to the Commissioner the amount which during the year ending on the date fixed by law for filing the return the corporation has distributed as a special dividend for the benefit of the persons named in such section.

Applying the rule above stated, it is held that the special dividend credit will be allowed to corporations organized under the China Trade Act (1922) which have merely credited such dividends on their books to the accounts of shareholders within the time required by law for distribution of such dividends in order to obtain the special dividend credit, where, under the certification of the Secretary of Commerce, it is shown that such dividends are unqualifiedly subject to the demand of the shareholders.

SECTION 19.262-4: Withholding by a China Trade Act corporation.

INTERNAL REVENUE CODE.

Regulations 103, amended. (See T. D. 5046, page 260.)

SUPPLEMENT L.—ASSESSMENT AND COLLECTION OF DEFICIENCIES.

SECTION 272.—PROCEDURE IN GENERAL.

SECTION 19.272-2: Collection of a deficiency. 1941-17-10694
I. T. 3471

INTERNAL REVENUE CODE.

The Soldiers' and Sailors' Civil Relief Act of 1940, deferring collection during military service of income tax due from "persons in military service," is not applicable with respect to taxes owed by the wife of any such person even though it is shown that the wife's ability to pay is materially impaired by reason of the service of the husband.

Advice is requested whether the wife of an officer in the military service, as well as the officer, may be relieved from immediate payment of income tax under section 513 of the Soldiers' and Sailors' Civil Relief Act of 1940 (Public, No. 861, Seventy-sixth Congress, Chapter 888, third session).

Section 101(1) and section 513 of the Soldiers' and Sailors' Civil Relief Act of 1940, which is entitled "An Act To promote and strengthen the national defense by suspending enforcement of certain civil liabilities of certain persons serving in the Military and Naval Establishments, including the Coast Guard," provide in part:

SEC. 101. (1) The term "persons in military service" and the term "persons in the military service of the United States," as used in this Act, shall include the *following persons and no others:* All members of the Army of the United States, the United States Navy, the Marine Corps, the Coast Guard, and all officers of the Public Health Service detailed by proper authority for duty either with the Army or the Navy. The term "military service," as used in this Act, shall signify Federal service on active duty with any branch of service heretofore referred to or mentioned as well as training or education under the supervision of the United States preliminary to induction into the military service. * * * [Italics supplied.]

* * * * * * *

SEC. 513. The collection from any person in the military service of any tax on the income of such person, whether falling due prior to or during his period

ability to pay such tax is materially impaired by reason of such service. No interest on any amount of tax, collection of which is deferred for any period under this section, and no penalty for nonpayment of such amount during such period, shall accrue for such period of deferment by reason of such nonpayment. The running of any statute of limitations against the collection of such tax by distraint or otherwise shall be suspended for the period of military service of any individual the collection of whose tax is deferred under this section, and for an additional period of nine months beginning with the day following the period of military service. The provisions of this section shall not apply to the income tax on employees imposed by section 1400 of the Federal Insurance Contributions Act.

In view of the provisions of the Act, as quoted above, the Bureau may not defer the collection of unpaid income taxes assessed against the wife of any individual in the military service, even though it can be shown that the wife's ability to pay the tax is materially impaired by reason of the service of the husband.

SECTION 274.—BANKRUPTCY AND RECEIVERSHIPS.

SECTION 19.274–1: Bankruptcy and receivership proceedings. 1941–8–10610 G. C. M. 22499

INTERNAL REVENUE CODE.

Priority rights of the Government with respect to income taxes in receivership cases.

An opinion is requested relative to the priority rights of the Government with respect to income taxes in receivership cases.

The first question presented is whether the tax due on the income received during the receivership has priority over administrative expenses such as receiver's fees, attorney's fees, etc.

Section 3466 of the Revised Statutes provides as follows:

SEC. 3466. Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority hereby established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.

In the case of *Michigan* v. *Michigan Trust Co., Receiver* (286 U S., 334), Mr. Justice Cardozo stated (at page 344) "* * * we think the annual taxes accruing while the receiver was in charge must be deemed expenses of administration * * *." In the case of *Wire Wheel Corporation of America et al.* v. *Fayette Bank & Trust Co. of Connersville, Ind., et al.* (30 Fed. (2d), 318), the court allowed the payment of the full amount due the United States as excise taxes on automobiles manufactured by the receiver prior to the payment of (1) State of Indiana personal property taxes incurred during receivership, (2) merchandise creditors of the receiver, (3) receiver's certificates, and (4) other miscellaneous receivership creditors. In that case fees of the receivers and attorneys were paid in full. In *Parks* v. *Central Door & Lumber Co. et al.* (102 Pac. (2d), 706),

claims against the receiver for social security taxes were held entitled to payment prior to the payment of wage claims incurred by the receiver during receivership.

In view of the foregoing, it is the opinion of this office that Federal income taxes, liability for which was incurred during receivership, are not entitled to priority in payment over court costs, to wit, filing fees, reasonable compensation for the receiver, and a reasonable attorney's fee, but that they are, generally speaking, entitled to priority in payment over other administrative or operating expenses by virtue of section 3466 of the Revised Statutes.

The second question presented is whether the Government's claims for taxes incurred prior to receivership would be equal or prior to the claim of a bonding company which, prior to the receivership, issued its bond as surety to cover a still earlier tax claim and was forced to pay the United States on the bond because of taxpayer's default.

Section 3468 of the Revised Statutes is as follows:

SEC. 3468. Whenever the principal in any bond given to the United States is insolvent, or whenever, such principal being deceased, his estate and effects which come to the hands of his executor, administrator, or assignee, are insufficient for the payment of his debts, and, in either of such cases, any surety on the bond, or the executor, administrator, or assignee of such surety pays to the United States the money due upon such bond, such surety, his executor, administrator, or assignee, shall have the like priority for the recovery and receipt of the moneys out of the estate and effects of such insolvent or deceased principal as is secured to the United States; and may bring and maintain a suit upon the bond, in law or equity, in his own name, for the recovery of all moneys paid thereon.

In the case of *United States* v. *National Surety Co.* (254 U. S., 73) it was held that section 3468 of the Revised Statutes, which gives a surety who pays the United States the amount due on a bond of an insolvent debtor the priority enjoyed by the United States over other creditors under section 3466 of the Revised Statutes, does not entitle the surety to share equally with the United States when the estate is insufficient to satisfy the unpaid claim of the United States. It is, therefore, the opinion of this office that the surety is entitled to satisfaction of its claim only after the claims of the United States are first satisfied.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

SECTION 275.—PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

SECTION 19.275–1: Period of limitation upon assessment of tax.

INTERNAL REVENUE CODE.

Regulations 103, amended. (See T. D. 5036, page 276.)

SECTION 362.—TAX ON MUTUAL INVESTMENT COMPANIES.

SECTION 19.362–1: Tax on mutual investment companies.

INTERNAL REVENUE CODE.

Regulations 103, amended. (See T. D. 5038, page 187.)

SECTIONS 391–396.

INTERNAL REVENUE CODE.

Regulations 103, amended. (See T. D. 5036, page 276.)

CHAPTER 2.—ADDITIONAL INCOME TAXES.

SUBCHAPTER A.—PERSONAL HOLDING COMPANIES.

SECTION 504.—UNDISTRIBUTED SUBCHAPTER A NET INCOME.

SECTION 19.504–1: Undistributed Subchapter A net income.

INTERNAL REVENUE CODE.

Regulations 103, amended. (See T. D. 5052, page 233.)

SECTION 506.—DEFICIENCY DIVIDENDS—CREDITS AND REFUNDS.

SECTION 19.506–6: Effect of deficiency dividends on dividends paid credit.

INTERNAL REVENUE CODE.

Regulations 103, amended. (See T. D. 5052, page 233.)

CHAPTER 2.—ADDITIONAL INCOME TAXES.

SUBCHAPTER E.—EXCESS PROFITS TAX.

SECTION 719.—BORROWED INVESTED CAPITAL.

REGULATIONS 109, SECTION 30.719–1: Borrowed invested capital. 1941–23–10732 I. T. 3481

INTERNAL REVENUE CODE.

The trade acceptances drawn by the N Company to the order of itself on, and "accepted" by the M Company on account of goods purchased by it from the N Company are bills of exchange within

the purview of section 719 of the Excess Profits Tax Act of 1940. Accordingly, any indebtedness evidenced thereby which was outstanding as of the beginning of a certain day is includible, under section 719(a), in that day's borrowed capital of the M Company for the purpose of determining, under section 719(b), its borrowed invested capital for that day.

Advice is requested whether certain trade acceptances drawn by the N Company to the order of itself on and "accepted" by the M Company in stated amounts and payable on certain future dates are evidence of outstanding indebtedness and includible in the borrowed capital of the M Company under section 719 of the Excess Profits Tax Act of 1940 (Subchapter E added to Chapter 2 of the Internal Revenue Code by section 201 of the Second Revenue Act of 1940, approved October 8, 1940). The following statement is printed on the face of each trade acceptance: "The transaction which gives rise to this instrument is the purchase of goods by the acceptor from the drawer."

Section 719(a)1 of the Act provides that the borrowed capital for any day of any taxable year shall be determined as of the beginning of such day and include the amount of outstanding indebtedness (not including interest, and not including indebtedness described in section 751 (b) relating to certain exchanges) evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust.

The question is raised as to whether the trade acceptances in question qualify as bills of exchange. In *Jones* v. *Revere Preserving Co.* (247 Mass., 225, 142 N. E., 70) it was stated that "While the instrument declared on is sometimes called a 'trade acceptance,' it has all the elements requisite to a bill of exchange as defined in the Negotiable Instruments Act * * *, and is to be so considered." In *Stafford* v. *Hill* (53 Calif. App., 337, 200 Pac., 33) it was held that there is nothing in the Federal Reserve Act (section 13), or in the regulations made thereunder, changing the character of trade acceptances, conforming therewith, as bills of exchange. In *Windsor Cement Co.* v. *Thompson* (86 Conn., 511, 86 Atl., 1) it was held that the Negotiable Instruments Act, defining a "bill of exchange" as an order which, *inter alia*, is payable to order or bearer, relates to negotiable bills only, and does not prevent an order not so payable, but merely to the plaintiff, from operating as a nonnegotiable bill of exchange. A trade acceptance as a bill of exchange within the meaning of section 719(a)1, supra, must evidence outstanding indebtedness. Hence, it must be in writing and have been so accepted by the drawee and be a definite and unconditional obligation to pay on demand or at a fixed or determinable future time a sum certain in money to, or to the order of, a specified person, or to bearer. (See generally *Hoyt* v. *Lynch*, 4 N. Y. Super, 328; *Sheets* v. *Coast Coal Co.*, 74 Wash., 327, 133 Pac., 433; *Pierce, etc., Mfg. Corp.* v. *Daniel Russell Boiler Works, Inc.*, 262 Mass., 242, 159 N. E., 625; *Camp* v. *Oakland Mtge. & Finance Co.*, 128 Cal. App., 238, 17 Pac. (2d), 151.)

In view of the foregoing, it is held that the trade acceptances submitted are bills of exchange within the purview of section 719 of the Excess Profits Tax Act of 1940. Accordingly, any indebtedness evi-

denced thereby which was outstanding as of the beginning of a certain day is includible, under section 719(a), in that day's borrowed capital of the M Company for the purpose of determining, under section 719(b), its borrowed invested capital for that day.

SECTION 725.—PERSONAL SERVICE CORPORATIONS.

(Also Section 275, Section 19.275–1; Sections 391–396.)

1941–6–10594
T. D. 5036

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PARTS 19, 30.—INCOME TAX AND EXCESS PROFITS TAX.

Regulations prescribed under the Second Revenue Act of 1940 with respect to personal service corporations.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

By reason of the enactment of the Second Revenue Act of 1940 (Public, No. 801, Seventy-sixth Congress, third session), approved October 8, 1940—

PARAGRAPH 1. The following regulations with respect to personal service corporations are prescribed under Title II of such Act, relating to the excess profits tax:

SEC. 725. PERSONAL SERVICE CORPORATIONS. (Second Revenue Act of 1940.)

(a) DEFINITION.—As used in this subchapter, the term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation and are the owners at all times during the taxable year of at least 70 per centum in value of each class of stock of the corporation, and in which capital is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists of gains, profits, or income derived from trading as a principal. For the purposes of this subsection, an individual shall be considered as owning, at any time, the stock owned at such time by his spouse or minor child or by any guardian or trustee representing them.

(b) ELECTION AS TO TAXABILITY.—If a personal service corporation signifies, in its return under Chapter 1 for any taxable year, its desire not to be subject to the tax imposed under this subchapter for such taxable year, it shall be exempt from such tax for such year, and the provisions of Supplement S of Chapter 1 shall apply to the shareholders in such corporation who were such shareholders on the last day of such taxable year of the corporation.

SECTION 30.725–1. *Taxation of personal service corporations.*—A personal service corporation is subject to the excess profits tax imposed under Subchapter E of Chapter 2 the same as any other domestic corporation unless it elects as to any taxable year not to be subject to such tax. If the corporation elects not to be subject to the excess-profits tax, the provisions of Supplement S (sections 391 to 396, inclusive, as added by section 502 of the Second Revenue Act of 1940) shall apply to the shareholders in such corporation who were such shareholders on the last day of the taxable year of the corporation. See section 19.394–1 of Regulations 103. In such case, the amount of the undistributed Supplement S net income shall be considered as paid in to the corporation as of the close of the taxable year as paid-in surplus or as a contribution to capital, and the amount of accumulated earnings and profits as of the close of such year shall be correspondingly reduced.

See section 394(d). (Section 62, 53 Stat., 32, 26 U. S. C., Sup., 62; sections 725, 729, Public, No. 801, Seventy-sixth Congress, third session.)

SEC. 30.725–2. *Definition of personal service corporation.*—(*a*) *In general.*—The term "personal service corporation" means a domestic corporation in which capital is not a material income-producing factor and the income of which is to be ascribed primarily to the activities of shareholders who (1) are regularly engaged in the active conduct of the affairs of the corporation, and (2) are the owners, throughout the entire taxable year, of at least 70 per cent in value of each class of stock of the corporation.

If 50 per cent or more of the gross income of a corporation consists of gains, profits, or income derived from trading as a principal, such corporation can not be considered to be a personal service corporation. As to corporations in which less than 50 per cent of the gross income is derived from trading as a principal, see (*c*) below.

(*b*) *Stock interest of shareholders.*—Shareholders regularly engaged in the active conduct of the affairs of the corporation and to whom the income of the corporation is primarily to be ascribed must own at all times during the taxable year at least 70 per cent in value of each class of stock of the corporation. If stock is owned by the spouse or minor child of an individual, or owned by the guardian or trustee of such spouse or child, such stock is treated as being owned by such individual.

A corporation can not be considered to be a personal service corporation for any taxable year if another corporation owns more than 30 per cent in value of any class of its stock at any time during such year. A corporation is an artificial entity and can not itself be regularly engaged in the active conduct of the affairs of another corporation within the meaning of section 725.

The fact that the ownership of shares in the corporation may change during the course of the taxable year does not take the corporation which is otherwise a personal service corporation out of that class unless at some time during the taxable year the ownership of more than 30 per cent in value of the shares of any class of stock passes into the hands of persons not regularly engaged in the active conduct of the affairs of the corporation.

(*c*) *Income to be ascribed primarily to the activities of shareholders.*—If employees other than shareholders contribute substantially to the services rendered by a corporation, such corporation is not a personal service corporation unless, in every case in which services are so rendered, the value of and the compensation charged for such services are to be attributed primarily to the experience or skill of the shareholders and such fact is evidenced in some definite manner in the normal course of the business or profession. The fact that the shareholders give personal attention or render valuable services to the corporation as a result of which its earnings are greater than those of a corporation engaged in a like or similar business or profession, the shareholders of which are not regularly engaged in the activities of the corporation, does not of itself constitute the corporation a personal service corporation.

Income of a corporation from merchandising or trading as a principal, directly or indirectly, in commodities or in the services of the others is not to be ascribed primarily to the activities of its shareholders. Income of a corporation from the conduct of an auction, agency, brokerage, or commission business strictly on the basis of a fee or commission may be so ascribed. If, however, either as a matter of business policy or by contract, the corporation assumes any such risks as those of market fluctuations, bad debts, or failure to accept shipments, or if it guarantees the accounts of the purchaser or is in any way accountable to the seller for the payment of the purchase price, the transaction is one of merchandising or trading, and this is true even though the goods are shipped directly from the producer to the consumer and are never actually in the possession of the corporation. The fact that earnings of the corporation are termed commissions or fees is not controlling. The fact that a commission or fee in a transaction is based on a difference in the prices at which the seller sells and the buyer buys raises a presumption that the transaction is one of merchandising or trading, and it will be so considered in the absence of satisfactory evidence to the contrary.

It may happen that a corporation is engaged in two or more businesses or professions which are more or less related. Thus, an engineering concern may also engage in contracting, which amounts to trading in materials and labor, or a brokerage concern may guarantee some of its accounts, or a photo-

of the corporation consisting of trading or guaranteeing of accounts or selling are negligible or merely incidental, and unless no appreciable part of the earnings is to be ascribed to such activities. See also (*e*) below relating to the employment of capital.

(*d*) *Shareholders regularly engaged in the active conduct of the affairs of the corporation.*—A corporation is not a personal service corporation unless shareholders who own at all times during the taxable year at least 70 per cent in value of each class of stock are regularly engaged in the active conduct of the affairs of the corporation. That such shareholders devote some of their time to the affairs of the corporation is not sufficient; they must with regularity devote substantial time and energy to the conduct of its affairs.

(*e*) *Capital as a material income-producing factor.*—In a personal service corporation capital must not be a material income-producing factor. Whether capital is a material income-producing factor is to be determined by reference to (*a*) the extent to which capital is required to carry on the business or profession, and (*b*) the extent to which capital is actually used in the production of income though not required by the primary activities of the corporation. If the use of capital is necessary to the production of the income of the corporation and is more than incidental, capital is a material income-producing factor and the corporation is not a personal service corporation. If a substantial portion of the income is attributable to a use of capital, whether or not connected with the primary activities of the corporation, capital is a material income-producing factor even though such use of capital is not necessary to such primary activities. The term "capital" as used in section 725 and in this section means not only capital actually invested by the shareholders but also capital obtained in other ways. Thus, capital may be borrowed either directly as shown by bonds, debentures, certificates of indebtedness, notes, bills payable, or other paper, or indirectly as shown by accounts payable or other forms of credit, or the business of the corporation may be financed in some other manner by its shareholders. If a substantial amount of capital is used to finance or carry the accounts of clients or customers, it will be inferred that because of competition or for other reasons such use of capital is necessary and more than incidental in order to secure or hold business which would otherwise be lost. If a corporation engaged in an agency, brokerage, or commission business regularly employs a substantial amount of capital to lend to its principals, to buy and carry goods on its own account, or to buy and carry odd lots in order that it may render more satisfactory service to its principals or customers, such corporation is not a personal service corporation. In general, the larger the amount of capital actually used the stronger is the evidence that capital is necessary and more than incidental and is a material income-producing factor.

The term "income" as used in section 725 and in this section means gross income. Capital is a material income-producing factor if its use results in a substantial amount of gross income, irrespective of the amount of net income, if any, such use produces.

(*f*) *Application of regulations; returns.*—No definite and conclusive tests can be prescribed by which it can be finally determined in advance of an examination of the corporation's income tax return whether it is or is not a personal service corporation. In the preceding subsections are set forth the general principles under which such determination will be made.

If a corporation claiming to be a personal service corporation signifies in its return under Chapter 1 for any taxable year its desire not to be subject to the excess profits tax under Subchapter E of Chapter 2 for such taxable year, it shall attach Form 1121PS, in duplicate, to its income tax return on Form 1120. In Form 1121PS there shall be stated (*a*) such facts as tend to show whether or not the corporation is a personal service corporation, including (1) the nature of its business, (2) the character, preferences, dividend rates, and other essential features of the various classes of its stock outstanding for any time during the taxable year, (3) the names and addresses of its several shareholders and their relationship to each other, (4) the number and classes of shares owned at any time during the taxable year by each shareholder and the portion of the year during which such shares were so owned, (5) the nature of the activities of the several shareholders on behalf of the corporation, and (6) the extent to which capital in any form is used in the business, and (*b*) the computation of the undistributed Supplement S net income for the taxable year, the names and addresses of all shareholders of the corporation at the close of the taxable year, the number and classes of shares held by each, and such other information as may be required by the form and the instructions printed on

the form or issued therewith. (Section 62, 53 Stat., 32, 26 U. S. C., Sup., 62; sections 725, 729, Public, No. 801, Seventy-sixth Congress, third session.)

SEC. 30.725–3. *Election as to taxability.*—The election as to taxability provided for in section 725(b) and the resulting exemption from tax have application only to the excess profits tax on domestic corporations imposed under Subchapter E of Chapter 2 as added by section 201 of the Second Revenue Act of 1940. The corporation may make such an election by signifying in its return under Chapter 1 its desire not to be subject to the excess profits tax. A new election is required for each taxable year. An amended return filed after the statutory period for filing the return (or after the last day of any extension period) is not a return within the meaning of section 725(b).

A domestic corporation which elects in its income tax return for a taxable year to be exempt from the excess profits tax for such year as a personal service corporation may, notwithstanding such election, file an excess profits tax return for such taxable year on Form 1121. Such return shall be complete in all respects except for the computation of the tax, and there shall be attached to it a statement that the corporation desires to be classified as a personal service corporation and not to be subject to the excess profits tax for the taxable year and that it has attached Form 1121PS in duplicate to its income tax return on Form 1120. An excess profits tax return made in this manner within the time prescribed by law will constitute a return within the meaning of section 712(a). In the case of a domestic corporation which files such a return electing therein as provided in section 712(a) or section 741 to compute its excess profits credit for such taxable year under section 713 or section 714 and which is subsequently determined not to be a personal service corporation, the amount of excess profits tax for such year shall be determined by the Commissioner in accordance with the election so made by the corporation with respect to the computation of its excess profits credit, and the excess profits tax so determined will constitute a deficiency which shall be assessed and collected in the same manner as in the case of a deficiency in income tax under Chapter 1. A corporation not filing an excess profits tax return for a taxable year within the time prescribed by law may not in any case elect to have the excess profits credit for such taxable year computed under section 713. The allowance of a credit or refund of any income tax overpaid by the shareholders of a corporation denied personal service classification is subject to the limitations provided in section 322. (Section 62, 53 Stat., 32, 26 U. S. C., Sup., 62; sections 725, 729, Public, No. 801, Seventy-sixth Congress, third session.)

PAR. 2. Regulations 103 [Part 19, Title 26, Code of Federal Regulations, 1940 Sup.] are amended as follows:

(A) The following is inserted immediately after section 19.373–1:

SEC. 502. TAX OF SHAREHOLDERS OF PERSONAL SERVICE CORPORATIONS. (Second Revenue Act of 1940.)

The Internal Revenue Code is amended by inserting after section 373 the following new Supplement:

"SUPPLEMENT S—TAX OF SHAREHOLDERS OF PERSONAL SERVICE CORPORATIONS.

"SEC. 391. APPLICABILITY OF SUPPLEMENT.

"If a personal service corporation (as defined in section 725) is exempt under such section for any taxable year from the excess profits tax imposed by such subchapter, the provisions of this Supplement shall be applicable with respect to each shareholder of such corporation who was a shareholder in such corporation on the last day of such taxable year of the corporation."

SEC. 19.391–1. *Applicability of Supplement S.*—If a personal service corporation (as defined in section 725 and the regulations thereunder) elects not to be subject to the excess profits tax for any taxable year, then sections 391 to 396, as added by section 502 of the Second Revenue Act of 1940, shall be applicable with respect to each person who was a shareholder of such corporation at the close of the taxable year of the corporation. (See section 725(b).)

"SEC. 392. UNDISTRIBUTED SUPPLEMENT S NET INCOME.

in section 393) minus the amount of the dividends paid during the taxable year. For the purposes of this section the amount of dividends paid shall be computed in the same manner as provided in subsections (d), (e), (f), (g), (h), and (i) of section 27 for the purpose of the basic surtax credit provided in section 27."

SEC. 19.392-1. *Undistributed Supplement S net income.*—The term "undistributed Supplement S net income" means Supplement S net income (as defined in section 393) minus the amount of dividends paid by the corporation during the taxable year. For the method of computing dividends paid, see subsections (d), (e), (f), (g), (h), and (i) of section 27 and the regulations thereunder.

"SEC. 393. SUPPLEMENT S NET INCOME.

"For the purposes of this chapter 'Supplement S net income' means the net income, except that there shall be allowed as additional deductions—

"(a) The Federal income tax payable under this chapter for the taxable year; and

"(b) In lieu of the deduction allowed by section 23(q), contributions or gifts, payment of which is made within the taxable year, to or for the use of donees described in section 23(q) for the purposes therein specified, to an amount which does not exceed 15 per centum of the corporation's net income, computed without the benefit of this subsection and section 23(q)."

SEC. 19.393-1. *Supplement S net income.*—The term "Supplement S net income" means the net income as defined in section 21, but computed without the deduction allowed under section 23(q), minus the sum of the following:

(*a*) The Federal income tax payable under Chapter 1 for the taxable year; and

(*b*) The amount of contributions or gifts made to or for the use of donees described in section 23(q) for the purposes therein specified, to an amount which does not exceed 15 per cent of the net income of the corporation computed without the benefit of sections 23(q) and 393(b).

The deductions allowed under section 393 for contributions or gifts made to or for the use of donees described in section 23(q) are in lieu of deductions otherwise allowable under section 23(q) and are allowable only for the taxable year in which such contributions or gifts are actually paid, regardless of when pledged and regardless of the method of accounting employed by the corporation in keeping its books and records.

The provisions of the last two paragraphs 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 amounts of contributions or gifts by corporations under section 393.

The method of computing Supplement S net income may be illustrated by the following example:

Example: The X Corporation, a personal service corporation, has for the calendar year 1940 a net income, as computed under Chapter 1, of $190,000. The Federal income tax payable under Chapter 1 for that year amounts to $45,600. Contributions or gifts payment of which is made during the taxable year to or for the use of donees described in section 23(q) for the purposes therein specified amount to $35,000. The Supplement S net income of the corporation is $124,400, computed as follows:

Net income under Chapter 1		$190,000
Add: Contributions deductible in computing net income under section 21		10,000
Net income computed without the benefit of any deduction for contributions		200,000
Less: Federal income tax	$45,600	
Contributions deductible under section 393(b) (15 per cent of $200,000)	30,000	
		75,600
Supplement S net income		124,400

"SEC. 394. CORPORATION INCOME TAXED TO SHAREHOLDERS.

"(a) GENERAL RULE.—The undistributed Supplement S net income of a personal service corporation shall be included in the gross income of the shareholders in the manner and to the extent set forth in this Supplement.

"(b) AMOUNT INCLUDED IN GROSS INCOME.—Each shareholder who, on the last day of the taxable year of the corporation, was a shareholder in such corporation shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend if on such last day there had been distributed by the corporation, and received by the shareholders, an amount equal to the undistributed Supplement S net income of the corporation for its taxable year.

"(c) CREDIT FOR OBLIGATIONS OF THE UNITED STATES AND ITS INSTRUMENTALITIES.—Each such shareholder shall be allowed a credit against net income, for the purposes of the tax imposed by section 11, 13, 14, 201, 204, 207, or 362, of his proportionate share of the interest specified in section 25(a) (1) or (2) which is included in the gross income of the corporation.

"(d) EFFECT ON CAPITAL ACCOUNT OF PERSONAL SERVICE CORPORATION.—An amount equal to the undistributed Supplement S net income of the personal service corporation for its taxable year shall be considered as paid in as of the close of such taxable year as paid-in surplus or as a contribution to capital, and the accumulated earnings and profits as of the close of such taxable year shall be correspondingly reduced, if such amount or any portion thereof is required to be included as a dividend in the gross income of the shareholders.

"(e) BASIS OF STOCK IN HANDS OF SHAREHOLDERS.—The amount required to be included in the gross income of the shareholder under subsection (b) shall, for the purpose of adjusting the basis of his stock with respect to which the distribution would have been made (if it had been made), be treated as having been reinvested by the shareholder as a contribution to the capital of the corporation; but only to the extent to which such amount is included in his gross income in his return, increased or decreased by any adjustment of such amount in the last determination of the shareholder's tax liability, made before the expiration of seven years after the date prescribed by law for filing the return.

"(f) PERIOD OF LIMITATION ON ASSESSMENT AND COLLECTION.—For period of limitation on assessment and collection without assessment, in the case of failure to include in gross income the amount properly includible therein under subsection (b), see section 275(d)."

SEC. 19.394–1. *Taxability of shareholders.*—If, by reason of an election under section 725, a personal service corporation is exempt for any taxable year from the excess profits tax imposed under Subchapter E of Chapter 2, the undistributed Supplement S net income of the corporation shall be treated as a dividend received by those who, at the close of the taxable year of the corporation, were the shareholders of the corporation and as such would have been entitled to receive such income as a dividend had it been distributed at that time. Each such shareholder for his taxable year in which or with which the taxable year of the corporation ends, shall include in his gross income his proportionate share of such undistributed Supplement S net income as though such proportionate share had been received as a dividend on the last day of the taxable year of the corporation. Such amount is to be determined by reference to the interest of the shareholder in the corporation, that is, by reference to the number of shares of stock owned and the relative rights of each class of stock if there are several classes of stock outstanding. Thus, if a personal service corporation has both common and preferred stock outstanding and the preferred shareholders are entitled to a specified dividend before any distribution may be made to the holders of the common stock, then the assumed distribution of the undistributed Supplement S net income must first be treated as a payment of the specified dividend on the preferred stock before any part may be allocated as a dividend on the common stock.

SEC. 19.394–2. *Credit for interest on obligations of the United States and its instrumentalities.*—Each shareholder of a personal service corporation who as of the last day of the taxable year of the corporation is required to include in his gross income his proportionate share of the undistributed Supplement S net income of the corporation shall, for the purposes of the tax imposed by section 11 (normal income tax), section 13 (tax on corporations in general), section 14 (tax on special classes of corporations), section 201 (tax on life insurance companies), section 204 (tax on insurance companies other than life or mutual), section 207 (tax on mutual insurance companies other than life), or section 362 (tax on mutual investment companies), be allowed a credit against net income of his proportionate share of the interest specified in section 25(a)(1), interest on United States obligations, or section 25(a)(2), interest on obligations of instrumentalities of the United States, which is included in the gross income of the corporation.

SEC. 19.394–3. *Effect on capital account of personal service corporation.*—If the undistributed Supplement S net income of a personal service corporation, or any portion thereof, for any taxable year is required to be included in the gross income of the shareholders, such undistributed Supplement S net income shall, for income tax and excess profits tax purposes, be treated as paid-in surplus or as a contribution to capital, paid in as of the close of such taxable year and the accumulated earnings and profits of the corporation shall be correspondingly reduced.

SEC. 19.394–4. *Basis of stock in hands of shareholders.*—If a shareholder of a personal service corporation is required to include in his gross income his proportionate part of the undistributed Supplement S net income of the corporation, the amount so included shall, for the purpose of adjusting the basis of his stock with respect to such proportionate part, be treated as a distribution actually made by the corporation and as a reinvestment in the corporation by the shareholder. It shall, however, be so treated only to the extent to which such amount is included in the return of the shareholder, increased or decreased by any adjustment of such amount in the last determination of the tax liability of the shareholder made before the expiration of seven years after the date prescribed by law for the filing of his return.

"SEC. 395. NONRESIDENT ALIEN INDIVIDUALS AND FOREIGN CORPORATIONS.

"In the case of a shareholder taxable under section 211(a) or 231(a), his distributive share of the undistributed Supplement S net income of the corporation required to be included in the gross income shall be considered as a dividend received by him from sources within the United States.

"SEC. 396. SHAREHOLDER'S TAX PAID BY CORPORATION.

"If a personal service corporation is exempt for any taxable year under section 725 from excess profits tax, it shall, at the time of filing its return, pay to the collector an amount equal to the amount that would be required by section 143(b) or section 144 to be deducted and withheld by the corporation if any amount required by this Supplement to be included in the gross income of the shareholder had been, on the last day of the taxable year of the corporation, paid to the shareholder in cash as a dividend. Such amount shall be collected and paid in the same manner as the amount of tax due in excess of that shown by the taxpayer upon a return in the case of a mathematical error appearing on the face of the return."

SEC. 19.396–1. *Tax of certain shareholders paid by the corporation.*—Since a shareholder's proportionate share of the undistributed Supplement S net income of a corporation electing not to be subject to the excess profits tax is taxable to such shareholder, the corporation is required, at the time of filing its income tax return under Chapter 1, to pay to the collector an amount equal to the amount that would be required by section 143(b) or section 144 to be deducted and withheld by the corporation had its undistributed Supplement S net income been actually paid in cash to its shareholders as a dividend on the last day of its taxable year.

(B) The following is inserted immediately after section 275:

SEC. 503. STATUTE OF LIMITATIONS IN CASE OF CONSTRUCTIVE DIVIDENDS. (Second Revenue Act of 1940.)

Section 275(d) of the Internal Revenue Code (relating to statute of limitations) is amended to read as follows:

"(d) CONSTRUCTIVE DIVIDENDS.—If the taxpayer omits from gross income an amount properly includible therein—

"(1) FOREIGN PERSONAL-HOLDING COMPANIES.—Under section 337(b) (relating to the inclusion in the gross income of United States shareholders of their distributive shares of the undistributed Supplement P net income of a foreign personal-holding company); or

"(2) PERSONAL SERVICE CORPORATIONS.—Under section 394(b) (relating to the inclusion in the gross income of shareholders of their distributive shares of undistributed Supplement S net income of a personal service corporation);

the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within seven years after the return was filed."

(C) Section 19.275–1(6) is amended to read as follows:

(6) If the taxpayer omits from gross income an amount properly includible therein under section 337(b) as his distributive share of the undistributed Supplement P net income of a foreign personal holding company (see sections 331 to 340, inclusive), or an amount properly includible therein under section 394(b) as his distributive share of the Supplement S net income of a personal service corporation (see sections 391 to 396, inclusive) the tax may be assessed at any time within seven years after the return was filed.

(D) The following is inserted immediately after section 216:

SEC. 504. CREDIT OF NONRESIDENT ALIEN OF TAX AS SHAREHOLDER IN PERSONAL SERVICE CORPORATION. (Second Revenue Act of 1940.)

Section 216 of the Internal Revenue Code (relating to credit against tax of a nonresident alien individual) is amended by adding at the end thereof a new sentence to read as follows: "A nonresident alien individual shall be allowed as a credit against his tax the amount required by section 396 to be paid by the personal service corporation of which he is a shareholder with respect to his tax liability under Supplement S."

(E) The following is inserted immediately after section 234:

SEC. 505. CREDIT OF FOREIGN CORPORATION OF TAX AS SHAREHOLDER IN PERSONAL SERVICE CORPORATION. (Second Revenue Act of 1940.)

Section 234 of the Internal Revenue Code (relating to credits against tax of foreign corporations) is amended by adding at the end thereof a new section to read as follows: "A foreign corporation shall be allowed as a credit against its tax the amount required by section 396 to be paid by the personal service corporation of which it is a shareholder with respect to its tax liability under Supplement S."

(Paragraph 2 of this Treasury decision is issued under the authority contained in sections 502–505 of the Second Revenue Act of 1940 (Public, No. 801, Seventy-sixth Congress, third session), and section 62 of the Internal Revenue Code (53 Stat., 32).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved February 5, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register February 6, 1941, 3.32 p. m.)

SECTION 729(a).—LAWS APPLICABLE: GENERAL RULE.

1941–7–10606
I. T. 3451

INTERNAL REVENUE CODE.

Questions and answers relating to the filing of excess profits tax returns for the taxable year 1940 under the Excess Profits Tax Act of 1940.

Advice is requested with respect to the filing of excess profits tax returns for the taxable year 1940 under the Excess Profits Tax Act of 1940. The questions raised are stated hereinafter in the same order and in substantially the same manner as presented.

Question: The various collectors of internal revenue are required to condition the granting of an extension of time for the filing of a corporation income tax return upon the filing of a tentative return on or before the date prescribed by law (Mim. 3361, C. B. IV–2, 69 (1925); Mim. 3789, C. B. IX–1, 126 (1930)). Will similar instructions be issued to the collectors with respect to excess profits tax returns?

Answer: The general authority granted to collectors by the provisions of sections 19.53–2 and 19.53–3 of Regulations 103, relating to the income tax under the Internal Revenue Code, and the instructions issued to them relative to extensions of time for filing income tax returns apply with equal force and effect to excess profits tax returns for 1940.

Question: Many corporations will be unable to determine by March 15, 1941, whether they should elect to compute the excess profits credit under section 713 or section 714 of the Internal Revenue Code.

(1) If they are to be required to file a tentative excess profits tax return as a condition to obtaining an extension of time, will they be required to answer question (e), relating to the above-mentioned election for computing excess profits credit, on page 1 of the tentative return?

Answer: No.

(2) Should a statement be attached to the tentative return which will recite, in substance, that for purposes of the tentative return the taxpayer makes no election in the matter of computing the excess profits credit and that the right is reserved to make such election at the time of filing the final return?

Answer: Yes.

Question: The members of an affiliated group of corporations will not be able to determine by March 15, 1941, whether they should (1) avail themselves of the privilege of filing a consolidated return and, if so, whether the consolidated excess profits credit should be computed under the income method or the invested capital method; (2) file separate corporate returns and, if so, whether the respective excess profits credits should be computed under the income method or the invested capital method. The questions raised in the preceding paragraph apply equally to affiliated groups and, in addition, the following questions are presented:

(1) On the assumption that extensions of time will be conditioned upon the filing of tentative returns, may the common

parent corporation obtain an extension for itself and all members of the group by filing an appropriate application accompanied by a single tentative return?

Answer: Yes. The application filed with the collector by the common parent corporation should, however, also include the name and address of each member of the group for which an extension is desired. In the event that any member of the group is located in a collection district different from the one in which the application is filed by the common parent, the collector of that district should be notified by the common parent when the requested extension has been duly authorized.

(2) Would it be necessary to file Form 851E (Affiliations Schedule) as a part of such tentative return?

Answer: No.

(3) Would it likewise be necessary for the tentative consolidated return to be accompanied by Forms 1122E (Return of Information and Authorization and Consent of Subsidiary Corporation) with respect to each member of the group, and would each such member be required to file a tentative Form 1122E with the appropriate collector?

Answer: No.

(4) Would the filing of a consolidated tentative return, whether or not accompanied by Forms 851E and 1122E, constitute a binding election with respect to the filing of a consolidated return?

Answer: No.

(5) Should each member of the group file a tentative return, and would such action estop all group members from later filing a consolidated return?

Answer: No.

1941–10–10634
Mim. 5175

Time for filing excess profits tax returns.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C., March 5, 1941.

Collectors of Internal Revenue, Internal Revenue Agents in Charge, and Others Concerned:

1. Attention is invited to section 30.729–1 of Excess Profits Tax Regulations 109 prescribed under the Excess Profits Tax Act of 1940, which provides that excess profits tax returns shall be filed at the same time and place as the time and place prescribed in sections 53 and 235 of the Internal Revenue Code and the income tax regulations under such sections for the filing of income tax returns, except that such excess profits tax returns for taxable years ending before December 31, 1940, which, if filed within the time prescribed in such regulations, would be filed before March 15, 1941, shall be filed on or before March 15, 1941.

2. It will be observed that under section 30.729–1 of Regulations 109 the last day on or before which certain excess profits tax returns for taxable years ended before December 31, 1940, are required to be filed (if no extension of time is granted) is March 15, 1941, although

the last day on or before which the income tax returns for such taxable years are required to be filed (if no extension of time is granted) is before March 15, 1941. Collectors may grant extensions of time beyond March 15, 1941, for the filing of excess profits tax returns for such taxable years even though an extension of time beyond March 15, 1941, may not be granted for the filing of the income tax returns for such taxable years because of the six months' limitation in section 53(a)2 of the Code. For example, income tax returns of corporations (except corporations described in section 19.53–3 of Regulations 103) for the period from January 1, 1940, to June 30, 1940, were required to be filed on or before September 15, 1940, and extensions of time for filing such income tax returns may not be granted beyond March 15, 1941, because of the limitation in section 53(a)2, but excess profits tax returns for such period are not required to be filed until March 15, 1941, and collectors may grant extensions of time beyond March 15, 1941, in the usual manner for the filing of such excess profits tax returns.

3. Correspondence regarding this mimeograph should refer to the number thereof and to the symbols IT:TM.

GUY T. HELVERING,
Commissioner.

1941–26–10757
Mim. 5204

Time for filing excess profits tax returns.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C., June 18, 1941.

Deputy Commissioners, Collectors of Internal Revenue, Internal Revenue Agents in Charge, and Others Concerned:

1. Reference is made to Mimeograph 5175 (page 285, this Bulletin), setting forth instructions regarding the granting of extensions of time within which to file excess profits tax returns on Form 1121 under the Excess Profits Tax Act of 1940, as amended.

2. No additional extensions of time will be granted for the filing of excess profits tax returns for the calendar year 1940. In no case, except in most unusual circumstances, will an extension of time for the filing of excess profits tax returns for fiscal years ending in 1941 be granted, and then only after submission to and approval by this office.

3. It is requested that each collector submit immediately a statement (marked for the attention of A&C:Col) showing the name and address of each corporation and the date to which an extension has been granted, and where the final or completed returns have not as yet been filed. Collectors west of the Mississippi River should forward these statements by air mail.

4. Correspondence regarding this mimeograph should refer to the number thereof and to the symbols IT:TM.

GUY T. HELVERING,
Commissioner.

SECTION 731.—CORPORATIONS ENGAGED IN MINING OF STRATEGIC METALS.

(Section 30.731–1, Regulations 109.) 1941–13–10661
I. T. 3463

INTERNAL REVENUE CODE.

The word "platinum," as used in section 731 of the Internal Revenue Code, as amended by section 201 of the Second Revenue Act of 1940, does not include iridium, osmium, ruthenium, rhodium, and palladium, commonly known as platinum metals.

Advice is requested by the M Mining Co. whether the word "platinum," as used in section 731 of the Internal Revenue Code, as amended by section 201 of the Second Revenue Act of 1940, includes iridium, osmium, ruthenium, rhodium, and palladium, commonly known as platinum metals. That section of the Code provides as follows:

SEC. 731. CORPORATIONS ENGAGED IN MINING OF STRATEGIC METALS.

In the case of any domestic corporation engaged in the mining of tungsten, quicksilver, manganese, platinum, antimony, chromite, or tin, the portion of the adjusted excess profits net income attributable to such mining in the United States shall be exempt from the tax imposed by this subchapter. The tax on the remaining portion of such adjusted excess profits net income shall be an amount which bears the same ratio to the tax computed without regard to this section as such remaining portion bears to the entire adjusted excess profits net income.

The M Mining Co. is a domestic corporation engaged in platinum placer mining in the Territory of Alaska. Its product is crude platinum mineral which is shipped for analysis, refinement, and marketing. Shipments of the crude platinum mineral analyze differently. A small amount of free gold is recovered in addition to the so-called platinum metals. Omitting all gold and impurities, the representative mean analysis of the product recovered by dredging consists of 84.65 per cent platinum, 10.30 per cent iridium, 2.36 per cent osmium, 2.17 per cent rhodium, 0.17 per cent ruthenium, and 0.35 per cent palladium. Iridium and the other metals named (other than platinum) are usually sold with platinum in alloy form.

It is held that the word "platinum," as used in section 731 of the Internal Revenue Code, as amended by section 201 of the Second Revenue Act of 1940, does not include iridium, osmium, ruthenium, rhodium, and palladium. Support for this conclusion may be found in the principle enunciated in I. T. 1601 (C. B. II–1, 190 (1923)), in which it was held that since section 304 of the Revenue Acts of 1918 and 1921 exempted from the profits taxes imposed by those Acts only the income derived from the mining of gold itself such exemption could not be extended to income derived from other metals, although they may have represented nothing more than by-products incidental to gold mining.

Accordingly, only the portion of the adjusted excess profits net income of the M Mining Co. attributable to the mining of platinum is exempt from the excess profits tax. The excess profits tax on the

remaining portion of such adjusted excess profits net income is an amount which bears the same ratio to the excess profits tax computed without regard to section 731 of the Internal Revenue Code, as amended, as such remaining portion bears to the entire adjusted excess profits net income. (See section 30.731–1 of Regulations 109.)

REGULATIONS 109, SECTION 30.731–1: Corporations which mine strategic metals. 1941–24–10743 I. T. 3482

INTERNAL REVENUE CODE.

The exemption from excess profits tax under section 731 of the Excess Profits Tax Act of 1940 in the case of a domestic corporate taxpayer engaged in the mining of strategic metals applies to that portion of the adjusted excess profits net income attributable to mining and to such milling processes as are treated as a part of mining for depletion purposes under section 19.23(m)–1(*f*) of Regulations 103, but does not apply to such income attributable to any milling processes of the taxpayer with respect to ore mined by others.

Advice is requested whether the M Company is exempt from the Federal excess profits tax on the adjusted excess profits net income attributable to the operation of a plant constructed by it for the milling of tungsten mined from its own property and also for the milling of tungsten mined by others from properties in that locality which could not be worked unless a mill was available.

Section 731 of the Excess Profits Tax Act of 1940 (Subchapter E of Chapter 2 of the Internal Revenue Code, as added by the Second Revenue Act of 1940), provides as follows:

CORPORATIONS ENGAGED IN MINING OF STRATEGIC METALS.

In the case of any domestic corporation engaged in the mining of tungsten, quicksilver, manganese, platinum, antimony, chromite, or tin, *the portion of the adjusted excess profits net income attributable to such mining* in the United States shall be exempt from the tax imposed by this subchapter. The tax on the remaining portion of such adjusted excess profits net income shall be an amount which bears the same ratio to the tax computed without regard to this section as such remaining portion bears to the entire adjusted excess profits net income. [Italics supplied.]

In connection with the phrase which is emphasized in the above quotation, attention is directed to section 30.731–1 of Regulations 109, which reads in part as follows:

(*b*) * * * The portion of the excess profits net income attributable to such mining is the gross income derived from strategic metals and arising out of operations which give rise to "gross income from the property," as defined in section 19.23(m)–(1)(*f*) of Regulations 103 * * * [less certain items not material here].

In view of the foregoing, it is held that the exemption from the excess profits tax provided in said section 731, supra, applies only to the portion of the adjusted excess profits net income of a domestic corporation which is attributable to the mining (including such milling processes as section 19.23(m)–1(*f*) of Regulations 103 treats as mining) of strategic metals therein enumerated under such circumstances as would entitle the producer of such natural resources to a depletion allowance with respect thereto. The exemption does not apply to that portion of the adjusted excess profits net income attributable to any milling processes of ore mined by others.

CHAPTER 36.—COLLECTION.

SUBCHAPTER B.—LIEN FOR TAXES.

SECTION 3672.—VALIDITY AGAINST MORTGAGEES, PURCHASERS, AND JUDGMENT CREDITORS.

1941-6-10591
Ct. D. 1484

FEDERAL TAXES—REVISED STATUTES, AS AMENDED—DECISION OF COURT.

LIEN FOR TAXES—CLAIM FOR WORK, LABOR, AND MATERIALS—ASSIGNMENT TO BANK—VALIDITY OF LIEN AGAINST AFTER-ACQUIRED INTANGIBLE PROPERTY—PRIORITY OF FEDERAL TAX LIEN.

A claim for work, labor, and materials furnished, evidences of which were assigned by the taxpayer to a bank for a valuable consideration, constitutes "property or rights to property," subject to lien for Federal taxes for the year 1936, within the meaning of section 3186 of the Revised Statutes, as amended, although such property was intangible in character and was acquired after the filing of the notices of lien. Such a lien, notices of which were filed by the collector as required by the statute, became effective as of the date upon which the assessment list, signed by the Commissioner, was received in the office of the collector asserting the lien, and was prior and superior to the rights of the assignee bank, whose claim accrued subsequent to the filing of the notices of lien against the taxpayer.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT.

Citizens State Bank of Barstow, Tex., appellant, v. *S. P. Vidal, Collector of Internal Revenue for the District of New Mexico; Magnolia Petroleum Co., a Corporation; Montgomery Transportation Co., Inc.; E. P. Kistler, doing business as "Buckeye Grocery Store"; Ed Chase; R. W. Cowell; D. B. DeHart; A. B. Flippin; J. W. Green; R. O. Johnson; L. J. Adkins; J. E. McDaniel; Arnold Nuttall; W. R. Rash; Bernice Warren; J. W. Wiles; L. B. Hancock; Grady Thompson, doing business as "Thompson Hardware Co."; and Harry V. Vance, Trustee in Bankruptcy, appellees.*

[114 Fed. (2d), 380.]

Appeal from the District Court of the United States for the District of New Mexico.

[July 19, 1940.]

OPINION.

MURRAH, District Judge, delivered the opinion of the court.

The Magnolia Petroleum Co., a corporation,[1] appropriately filed its bill of interpleader,[2] acknowledged its debt to the Montgomery Transportation Co., Inc.,[3] for work, labor, and materials furnished to it by Montgomery, deposited the debt, in the sum of $5,151.49, in the registry of the court and asked to be discharged. All parties defendant, including appellant and appellees, answered, claiming prior and superior rights to the fund. Appellee, S. P. Vidal, collector of internal revenue for the district of New Mexico,[4] claims the fund in satisfaction of a deficiency assessment for income tax in the sum of $4,472.13, with penalties, for taxes for the year of 1936, due the United States Government. To perfect the said lien, the collector filed notice of the same in the office of the clerk of the United States District Court at Santa Fe, N. Mex., on December 13, 1938; in the office of the county clerk of Lea County, at Lovington, N. Mex. (the domicile

[1] Hereinafter called Magnolia.
[2] Under authority of Acts of Congress of date January 20, 1936, Chapter 13, section 1, 49 Stat., 1096 (U. S. C. A., Title 28, section 41(26)).
[3] Hereinafter called Montgomery.
[4] Hereinafter called collector.

of Montgomery), on December 14, 1938; in the office of the county clerk of Eddy County, State of New Mexico, at Carlsbad, N. Mex. (where part of the work was performed and material furnished), on March 13, 1938; in the office of the clerk of the United States District Court for the Western District of Texas, at Pecos, Tex., on December 16, 1938, and in the office of the county clerk of Winkler County, at Kermit, Tex. (where part of the work was performed and material furnished), on December 13, 1938, as provided by applicable statutes.[5]

The warrant for distraint and notice of levy was served upon Magnolia June 16, 1939, based upon a deficiency income tax assessment against Montgomery. Appellant, Citizens State Bank of Barstow, Tex.,[6] made claim to the fund by virtue of written assignments, executed and delivered to it by Montgomery, for which it paid a valuable consideration, without actual notice of the filing of notice by the collector, and which said assignments covered work in Texas and New Mexico for and on behalf of Magnolia, prior to the date warrant for distraint and notice of levy was served upon the Magnolia, but after the filing of the notice of the lien aforesaid.

The fund, in question, represents the payment of a debt from the Magnolia to Montgomery for work, labor and materials furnished, evidence of which was assigned to the bank in the manner aforesaid and the sole question presented here is the priority of the claim of the collector and the Bank.

The trial court held that the laborers and materialmen had first claim to the fund; that the collector of internal revenue had second claim to the fund; that the Bank had third claim to the fund. The Bank appeals "only from that portion of the said judgment which denies its priority to the claim of the collector." The facts are agreed and are correctly set forth in the court's findings. They evidence the following material facts: Montgomery Transportation Co., Inc., a New Mexico corporation, was engaged in what might be termed oil field work; was employed and did perform labor and furnish materials in Texas and New Mexico for the Magnolia. To obtain money with which to meet current obligations, meet its pay roll and operating expenses, Montgomery carried its itemized statements of work performed and material furnished, approved by Magnolia, to the Bank and for a cash consideration transferred and assigned to the Bank the itemized statements of money due and to become due thereunder. It was understood between the Bank, the Magnolia and Montgomery that from the amount due Montgomery from Magnolia there would be deducted the purchase price of Magnolia petroleum products purchased from the Magnolia by Montgomery, in the operation of its business, and the net amount due after deductions, from time to time, would be retained by the Bank and the amount so retained credited in payment of the written assignments on due date. This course of dealing continued from the year of 1936 until about the 16th of June, 1939, but the assignments in question were for May 1, 13, 16, 22, 31, June 6, 12, and 14, 1939. At that time the assignments aggregated $13,637.42 for work, labor and materials furnished Magnolia by Montgomery, but after deducting the credits for petroleum products furnished by Magnolia to Montgomery there remained the sum now deposited in the registry of the court by Magnolia.

On June 16, 1939, the collector caused to be served on the Magnolia notice of levy and warrant of distraint, making demand upon Magnolia "for the amount now owing from you to the said Montgomery Transportation Co., Inc.," which precipitated the bill of interpleader. The assignments from the Mont-

[5] Section 3186 of the Revised Statutes of the United States, as amended by section 613 of the Revenue Act of 1928 (Act of May 29, 1928, 45 Stat., 875) and section 509 of the Revenue Act of 1934 (Act of May 10, 1934, 48 Stat., 757; 26 U. S. C. A., section 3672), which reads in part as follows:

"VALIDITY AGAINST MORTGAGEES, PLEDGEES, PURCHASERS, AND JUDGMENT CREDITORS.

"(a) INVALIDITY OF LIEN WITHOUT NOTICE.—Such lien shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the collector—

"(1) UNDER STATE OR TERRITORIAL LAWS.—In accordance with the law of the State or Territory in which the property subject to the lien is situated, whenever the State or Territory has by law provided for the filing of such notice; or

"(2) WITH CLERK OF DISTRICT COURT.—In the office of the clerk of the United States district court for the judicial district in which the property subject to the lien is situated, whenever the State or Territory has not by law provided for the filing of such notice; or

"(3) WITH CLERK OF DISTRICT COURT OF THE UNITED STATES FOR THE DISTRICT OF COLUMBIA.—In the office of the clerk of the District Court of the United States for the District of Columbia, if the property subject to the lien is situated in the District of Columbia."

[6] A banking corporation organized under the laws of the State of Texas, and doing business in Barstow, Ward County, Tex., and hereinafter called Bank.

gomery to the Bank are valid, in good faith and made in the regular course of business and the Bank had no actual knowledge of the income tax delinquency or notice of the filing of the tax lien.

During the pendency of the suit, Montgomery was adjudged a bankrupt and the trustee in bankruptcy was substituted party defendant and made claim to the fund, contending it should be distributed through bankruptcy, but the assignments to the Bank and the notice of tax lien having been made and filed more than four months prior to adjudication of bankruptcy, it was decreed that the trustee in bankruptcy take nothing.

In the last analysis the sole question in this appeal is whether or not the filing of the notice of a tax lien by the collector, in the manner established by these facts, gave the collector a prior and superior lien to the Bank, as assignee of the taxpayer. This is the controlling question. The question turns on the construction of the applicable provisions of the Internal Revenue Code,[7] which provides for a lien in behalf of the Government for unpaid taxes, the scope of the lien and the manner of its enforcement.[8]

The question presented may be considered under two propositions. First, is the fund against which the lien is sought to be enforced "property or rights to property, whether real or personal, belonging to such person (taxpayer)," within the context and meaning of the statute?[9]

A claim for work, labor, and material furnished is evidence of a debt and a chose in action; it is so treated by the parties here. Is it "property or rights to property"? If it is not "property" within the meaning of the Act then no lien can attach; if it is "property" within the meaning of the Act then the lien did attach from the date the assessment list was received in the office of the collector of internal revenue asserting the lien, provided notice of the said lien covering the tax assessment was filed as provided by the Act,[10] subject to the prior and intervening rights of adverse claimants.[11]

The statute covering collection of taxes is broad and comprehensive and Congress intended to subject all of a taxpayer's property, except that specifically exempt to the payment of taxes.[12] "Property" is a word of very broad meaning and when used without qualification, may reasonably be construed to include obligations, rights and other intangibles, as well as physical things.[13] "Property" within the tax laws should not be given a narrow or technical meaning.[14]

The evidence of debt for labor, work, and materials furnished was subject to ownership (the Bank claims ownership); it was subject to transfer (it was transferred), and exclusive possession and enjoyment and may be brought within the dominion and control of a court, through some recognized process (it is the subject matter of the controversy here). Under well recognized authority these are the essential ingredients of "property" where value is the test.[15]

The claim which has now ripened into the fund deposited into the registry of this court is "property or rights to property," although intangible in character. Appellant cites *United States* v. *Western Union Telegraph Co.*[16] as authority that a lien for taxes on "property or rights to property" contemplates a lien on tangible property only. An examination of the facts in the Western Union Telegraph Co. case clearly indicates that the rights of the parties to the intangible property sought to be taxed were fixed long prior to attachment of the tax lien of the United States. There the Western Union Telegraph Co. became obligated to pay to the stockholders of the Northwestern Telegraph Co. certain fixed profits and the stockholders of the latter company were the third party beneficiaries to the property and the Northwestern Tele-

[7] Title 26, U. S. C. A., sections 3670, 3671, and 3672, Revised Statutes, 3186, as amended.

[8] *Cannon* v. *Nicholas, Collector of Internal Revenue* (80 Fed. (2d), 934 [Ct. D. 1113, C. B. XV–1, 313 (1936)]).

[9] Title 26, U. S. C. A., section 3670, 53 Stat., 448, which reads as follows:

"PROPERTY SUBJECT TO LIEN.—If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, penalty, additional amount, or addition to such tax, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person."

[10] *United States* v. *Rosenfield et al.* (26 Fed. Supp., 433).

[11] *Exchange National Bank of Tulsa* v. *Davy et al.* (13 Fed. Supp., 226).

[12] *Cannon* v. *Nicholas, Collector of Internal Revenue*, supra.

[13] *Fidelity & Deposit Co. of Maryland* v. *Arenz* (290 U. S., 66); *Matter of Dunfee* (219 N. Y., 188, 114 N. E., 52); *Gaddy* v. *Witt* (Tex. Civ. App.) (142 S. W., 926).

[14] *Commissioner of Internal Revenue* v. *Stephens-Adamson Mfg. Co.* (51 Fed. (2d), 681 [Ct. D. 432, C. B. X–2, 228 (1931)]).

[15] *Gleason* v. *Thaw* (236 U. S., 558).

[16] 50 Fed. (2d), 102.

graph Co. did not own, possess, or control the property at the time the tax lien was sought to be enforced against it. While in the instant case the claim of the Bank to the fund in question accrued subsequent to the filing of the tax lien against the taxpayer.

Appellant does not contend that it comes within the "security" exemption.[17] Conceding that appellant is a "mortgagee, pledgee, purchaser or judgment creditor," and therefore entitled to the protective provisions of subsection (a), 26 U. S. C. A., section 3672, it is argued that the transitory situs of the chose in action renders nugatory the notice of filing of the tax lien, either at the domicile of the owner, which is Lea County, N. Mex., or in Winkler County, Tex., and Eddy County, N. Mex., where the work was performed and materials furnished and did not charge the Bank with notice, as contemplated by the protective provisions of the Act. We are, thereby, asked to decide the situs of the "property," or when translated into the language of the Act, the place where "situated." In our view, it is unnecessary for us to decide the situs of the "property," or whether or not the laws of the State of Texas or New Mexico provide for the filing of the notice of tax lien against "property" falling within this classification. If this "property" does not have a situs in Texas or New Mexico, or either of them, as contemplated by the applicable laws of the States, the disjunctive provisions of subdivision (a)2, Title 26, U. S. C. A., section 3672, provide for the filing of the notice with the court clerk of the United States district court, where the "property" is situated. Therefore, in December, 1938, when the notice of the tax lien was filed both with the United States Court clerk for the Western District of Texas, and the United States Court clerk for the District of New Mexico, the "property" was situated either at the domicile of Montgomery in Lea County, N. Mex., or the place where the work was performed and materials furnished, in Winkler County, Tex., and Eddy County, N. Mex.

Out of an abundance of precaution the collector filed notice of the lien at the domicile of the taxpayer and where the work was performed and materials furnished. It is significant to note that at that time the equities of the Bank had not attached, because evidence of the fund had not been assigned. The collector met every requirement of the Act when on December 21, 1938, after notice and demand for payment and refusal to pay the tax assessments, he caused the same to be recorded in the offices of the United States District Court for the District of New Mexico; the county clerk of Lea County, N. Mex.; the United States District Court for the Western District of Texas and the county clerk at Winkler County, Tex.

The tax lien upon all the "property and rights to property" of Montgomery, including the fund, in question, became effective as of the date upon which the assessment list, signed by the Commissioner of Internal Revenue, covering the assessments was received in the office of the collector of the district of New Mexico and became a valid lien against the claims of Montgomery for work, labor and materials furnished for Magnolia. They were thereafter assigned and transferred to the Bank, subject to the prior and subsisting lien of the United States, under Title 26, U. S. C. A., section 3670, 3671, and 3672, Revised Statutes, section 3186.[18]

The judgment is affirmed.

1941–9–10620
I. T. 3454

INTERNAL REVENUE CODE.

The statute enacted by the legislature of the State of Vermont, approved March 24, 1933 (No. 42, Session Laws of Vermont, 1923, page 69—now sections 2716–2718, Public Laws of Vermont), is accepted by the Bureau as the legislation authorized under section 3186, Revised Statutes, as amended (now section 3672, Internal Revenue Code, as amended), authorizing the filing of notice of Federal tax liens with certain designated county or other local officials.

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[17] 26 U. S. C. A., subsection (b) of section 3672.
[18] *Equitable Life Assurance Society of the United States* v. *Moore et al.* (29 Fed. Supp., 179; *United States* v. *Rosenfield et al.*, supra.

CHAPTER 38.—MISCELLANEOUS PROVISIONS.

SECTION 3798.—EXEMPTION OF INSOLVENT BANKS FROM TAX.

1941–21–10719
G. C. M. 22656

INTERNAL REVENUE CODE.

The immunity from taxation provided by section 3798(b) of the Internal Revenue Code in the case of banks and trust companies falling within the provisions of that section terminates when the balance sheets of such bank or trust company show earnings in excess of outstanding depositors' claims, and, within the limits prescribed by that section and the applicable regulations, taxes may then be assessed and collected.

An opinion is requested with respect to the extent to which immunity from taxation should be accorded banks and trust companies under section 3798(b) of the Internal Revenue Code (implemented by Treasury Decision 4958, Appendix to Regulations 103, page 759, as amended) in a situation wherein State or Federal banking authorities refuse to permit payment to depositors who have previously waived a portion of their deposit claims for a lien on subsequent earnings of the bank until the bank is able to pay off such claims and still retain in capital, surplus, and undivided profits an aggregate sum, or reserve, in excess of 10 per cent of the amount of the current deposit liability.

Section 3798 of the Internal Revenue Code, supra, reads in part as follows:

(b) Whenever any bank or trust company * * * has been released or discharged from its liability to its depositors for any part of their claims against it, and such depositors have accepted, in lieu thereof, a lien upon subsequent earnings of such bank or trust company, * * * no tax shall be assessed or collected * * * which shall diminish the assets thereof which are available for the payment of such depositor claims and which are necessary for the full payment thereof.

Section 464A.7 of Treasury Decision 4958, supra, reads in part as follows:

Earnings.—(*a*) *Availability for tax collection.*—Earnings of a bank within subsection (b), whether from segregated or unsegregated assets, which are necessary for, applicable to, and actually used for, payment of depositors' claims under an agreement, are within the immunity of the section. If only a portion or percentage of income from segregated or unsegregated assets is available and necessary for payment of depositors' claims, the remaining income is available for tax collection. Earnings of the bank's first fiscal year ending after the making of the agreement not applicable to payment of depositors will be assumed to be applicable for collection of any tax due prior or subsequent to execution of the agreement. Earnings of subsequent fiscal periods from unsegregated assets not applicable to depositors' claims will be assumed to be applicable to payment of taxes as to which immunity under the section has not previously attached. Earnings from segregated assets are available for collection of tax, whether previously uncollectible under the section or not, after depositors' claims against such assets have been paid in full. * * *.

Some of the banks and trust companies contend that because banking authorities require the withholding of earnings from depositors until the above-mentioned reserve or "cushion" fund to cover contingent future losses is built up, the earnings attributable to such reserve fund are not "available" for payment of claims of depositors and, therefore, the immunity provided by section 3798 of the Code should be extended

until earnings are sufficient to cover the reserve or "cushion" fund requirements plus the claims of depositors. Irrespective of whether the latter conclusion follows from the premise upon which it is based, this office believes the only reasonable view is that earnings are "available," within the meaning of that term as used in the statute, even though State or Federal banking authorities will not permit actual payment to depositors out of earnings attributable to the reserve or "cushion" fund. It is believed that the statute intends that the immunity should terminate if and when there are earnings over and above the amount necessary to pay claims of depositors in full, regardless of any additional banking requirement similar to that here under consideration. That conclusion is not inconsistent with the position taken in section 464A.7 of Treasury Decision 4958, supra, wherein it is stated in part that "Earnings of a bank within subsection (b), whether from segregated or unsegregated assets, which are necessary for, applicable to, and actually used for, payment of depositors' claims under an agreement, are within the immunity of the section." The statute under consideration herein was primarily intended to benefit the depositors, not the bank, stockholders, and general creditors. (See section 464A.4 of Treasury Decision 4958, supra.) It seems clear that Congress did not intend that earnings of a bank should be immune until State or Federal banking authorities feel that capital, surplus, and undivided profits are sufficiently built up to permit payment of depositors' claims.

Earnings over and above the amount necessary and available to pay claims of depositors in full should, for Federal tax purposes, be determined from the balance sheet of the bank. Lifting the immunity with respect to earnings in excess of the amount which covers in full the claims of depositors, even though the reserve or "cushion" fund is still being made up, does not "diminish the assets thereof which are available for the payment of such depositor claims and which are necessary for the full payment thereof."

In view of the foregoing, it is the opinion of this office that as soon as balance sheets of such a bank or trust company show earnings in excess of outstanding depositors' claims, the immunity provided by section 3798 of the Internal Revenue Code terminates and, within the limits prescribed by that section and the applicable regulations, taxes may be assessed and collected.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

B. REVENUE ACT OF 1938.

SUBTITLE B.—GENERAL PROVISIONS.

PART II.—COMPUTATION OF NET INCOME.

SECTION 22(c).—GROSS INCOME: INVENTORIES.

ARTICLE 22(c)-8: Inventories of retail merchants.

REVENUE ACT OF 1938.

Regulations 101, amended. (See T. D. 5048, page 200.)

SECTION 23(a).—DEDUCTIONS FROM GROSS INCOME: EXPENSES.

ARTICLE 23(a)-1: Business expenses.

REVENUE ACT OF 1938.

Expenses incurred in production of taxable income. (See I. T. 3452, page 205.)

SECTION 23(e).—DEDUCTIONS FROM GROSS INCOME: LOSSES BY INDIVIDUALS.

ARTICLE 23(e)-1: Losses by individuals. 1941-2-10559
G. C. M. 22461

REVENUE ACT OF 1938.

Where a partnership realizes a net gambling gain and a member of the partnership sustains a net individual gambling loss, the member's share of net partnership gambling gain may properly be reduced by his individual net gambling loss.
G. C. M. 21478 (C. B. 1939-2, 159) revoked.

In G. C. M. 21478 (C. B. 1939-2, 159) it was held that the taxpayer's share of the gains from wagering derived by a partnership of which he was a member may not be reduced by his net individual wagering loss.

In that case A was a member of a partnership which was engaged in the business of accepting wagers on horse racing. A personally bet large amounts with handbooks other than those operated by the partnership. He sustained a net loss in 1938 on such individual wagering transactions, whereas a net gambling gain was derived by the partnership.

In *Jennings* v. *Commissioner* (110 Fed. (2d), 945, certiorari denied, 61 S. Ct., 169), the court reversed the Board of Tax Appeals memorandum opinion, and held that a member of a partnership may offset his gambling losses as an individual against his share of partnership gains from gambling to the extent of such gains. (See generally *Neuberger* v. *Commissioner*, 61 S. Ct., 97, Ct. D. 1470, C. B. 1940-2, 228.)

In view of the position taken by the court as indicated by the decision above referred to, it is held that A's share of the net partnership gambling gain may properly be reduced by his net individual gambling loss.

G. C. M. 21478, supra, is revoked.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

ARTICLE 23(e)-1: Losses by individuals.

REVENUE ACT OF 1938.

Losses on account of payments for stock after stock becomes worthless. (See I. T. 3479, page 212.)

SECTION 23(g).—DEDUCTIONS FROM GROSS INCOME: CAPITAL LOSSES.

ARTICLE 23(g)-1: Capital losses.

REVENUE ACT OF 1938.

Losses on account of payments for stock after stock becomes worthless. (See I. T. 3479, page 212.)

SECTION 23(m).—DEDUCTIONS FROM GROSS INCOME: DEPLETION.

ARTICLE 23(m)-1: Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.

REVENUE ACT OF 1938.

Status of oil and gas leasing transactions. (See G. C. M. 22730, page 214.)

ARTICLE 23(m)-9: Determination of mineral contents of mines and of oil or gas wells.

REVENUE ACT OF 1938.

Regulations 101, amended. (See T. D. 5054, page 227.)

SUBTITLE C.—SUPPLEMENTAL PROVISIONS.

SUPPLEMENT A.—RATES OF TAX.

SECTION 101.—EXEMPTIONS FROM TAX ON CORPORATIONS.

ARTICLE 101(12)-1: Farmers' cooperative marketing and purchasing associations. 1941-1-10551 G. C. M. 22364

REVENUE ACT OF 1938 AND INTERNAL REVENUE CODE.

The M Company was organized to make possible the acquisition, control, conservation, and beneficial use by its members of certain grazing lands in Montana. Its activities consist of leasing or otherwise acquiring the lands and apportioning them among its members according to the number of cattle to be grazed. All of its income, consisting of fees and assessments collected from its members, is used to defray the cost of procuring the lands and for other necessary expenses. *Held*, the company is entitled to exemption under section 101(12) of the Revenue Act of 1938 and the Internal Revenue Code.

An opinion is requested whether the M Company is entitled to exemption from Federal income taxation under section 101(12) of the Revenue Act of 1938 and the Internal Revenue Code.

The M Company was incorporated in 1935 under the Montana Grazing Act of 1935. (Chapter 195, Laws of the Twenty-fourth Legis-

lative Assembly, State of Montana; Revised Code of Montana, 1935, sections 7364.7 to 7364.29, inclusive.) As set forth in its articles of incorporation prior to their amendment in 1939, the company was incorporated to organize a cooperative grazing district association. It has no capital stock and is not operated for profit. In the articles of incorporation it is provided that the "* * * purpose for which it is formed is to make possible the acquisition, control, conservation, and beneficial use by its members of certain grazing lands lying in ——— County, Mont., to the end that the members of the association may stabilize their farming and ranching operations." While the Montana Grazing Act of 1935 was repealed by the Montana Grass Conservation Act of 1939 (chapter 208, Laws of Twenty-sixth Legislative Assembly, State of Montana), and, in accordance with the provisions of that act, the M Company filed amended articles of incorporation to conform with the provisions thereof, the nature and purposes of the corporation and the method of operation are substantially the same under the later act.

The association ascertains the number of head of live stock proposed to be grazed each year by members, leases or otherwise acquires sufficient pasture land for grazing purposes, and divides such land proportionately among its members in order that they may graze their stock thereon. The association derives its income from membership fees and pro rata assessments of grazing fees, which are charged against the members for every head of stock grazed during each month of the grazing season. Although different fees are charged for the various kinds of cattle grazed, such fees are based upon the actual cost of procuring grazing land, plus the necessary costs of operating the association. The income is used to defray the costs of operation.

Section 101(12) of the Revenue Act of 1938 and of the Internal Revenue Code provides that the following organizations shall be exempt from Federal income tax:

> (12) Farmers', fruit growers', or like associations organized and operated on a cooperative basis * * * for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

Article 101(12)-1(*b*) of Regulations 101 and section 19.101(12)-1(*b*) of Regulations 103 provide in part as follows:

> Cooperative associations engaged in the purchasing of supplies and equipment for farmers, fruit growers, *live-stock growers*, dairymen, etc., and turning over such supplies and equipment to them at actual cost, plus the necessary operating expenses, are exempt. * * * [Italics supplied.]

Under the above-quoted provisions of the regulations, it seems clear that the instant association is of the type to which section 101(12), supra, applies. It also appears that the association is, under its articles of incorporation, organized and operated on a cooperative basis. If the acquisition of grazing by the association and the allocation thereof to its members for their use in grazing their live stock is tantamount to "the purchasing of supplies * * * for the use of members," the facts not only warrant the conclusion that the corporation was organized for the purpose of purchasing supplies for the use of its members, but that it furnished such "supplies" to its members at cost, plus the necessary cost of operation.

In defining the phrase "supplies and equipment" as used in section 101(12), article 101(12)-1(*b*) of Regulations 101 and the correspond-

ing provisions of Regulations 103 provide that it "* * * includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm * * *." In view of the fact that such provisions cover cooperative associations engaged in purchasing supplies and equipment for live-stock growers and dairymen as well as farmers and fruit growers, it is believed the words "farm" or "farmer," as used in defining the term "supplies and equipment," must be construed to include live-stock growers, dairymen, and fruit growers. Under such construction and for the purpose of this opinion, the term "supplies" would be defined to include groceries and all other goods and merchandise used by a "live-stock grower" in the operation and maintenance of a live-stock grower's farm. The question for determination is, therefore, whether the acquisition of grazing, by purchase or lease, by the instant cooperative association is a "supply" within the definition.

In S. M. 2288 (C. B. III–2, 233 (1924)), it is held that a company organized for the purpose of purchasing and furnishing supplies to various local citrus fruit growers' associations is entitled to exemption as a fruit growers' association where, in order to supply crates at the lowest cost, it purchased timberland and converted the timber into crates. That ruling reads in part as follows:

> * * * In order to supply crates at the cheapest possible price to its members and in view of the constantly advancing prices charged for crates, the company instead of buying crates upon the market bought large tracts of timberlands and a number of crate mills, and hired labor to put together and fabricate the crates which the company supplied to its members. The ownership of these lands and crate mills is incidental to the business of the company. No crates, fertilizers, or other supplies are sold to, or can be bought by, outsiders. The company clearly acts as a purchasing agent within the meaning of section 231(11) of the Revenue Act of 1921, although in the process of furnishing crates and fertilizers at the lowest possible price it buys the raw materials rather than the completed articles and expends a certain amount of labor upon them before turning over the completed crates and fertilizers to its members. By these operations the company merely increases its efficiency as a purchasing agent, the function of such an agent being to secure the benefit of the lowest possible price for supplies for its members. * * *

It seems apparent that the instant association, by acquiring grazing lands and apportioning them among its members for use in grazing their cattle, furnishes its membership a "supply" within the aforesaid definition. Grazing is a supply to a live-stock grower just as seeds are a supply to a farmer or as crates are a supply to a fruit grower. Furthermore, it will be noted from the definition of "supplies and equipment" that it "* * * *includes* groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm * * *." [Italics supplied.] The use of the word "includes" in this definition is, it is believed, merely for the purpose of specifying, not excluding, what shall be covered by that phrase. Should the word "includes" be held to have an exclusive connotation, nevertheless, the phrase "all other goods" in the definition is sufficiently broad to include grazing.

In view of the foregoing, it is the opinion of this office that the M Company is exempt from Federal income tax under the provisions of section 101(12) of the Revenue Act of 1938 and the Internal Revenue Code.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

SUPPLEMENT B.—COMPUTATION OF NET INCOME.

SECTION 115.—DISTRIBUTIONS BY CORPORATIONS.

ARTICLE 115-5: Distributions in liquidation.

REVENUE ACT OF 1938.

Extending time set for completion of liquidation. (See I. T. 3445, page 250.)

SECTION 116.—EXCLUSIONS FROM GROSS INCOME.

REVENUE ACT OF 1938.

Meaning of term "coastwise," as used in G. C. M. 22383 (C. B. 1940-2, 227). (See I. T. 3461, page 251.)

REVENUE ACT OF 1938.

Wages of seamen employed on vessels engaged in coastwise trade. (See I. T. 3467, page 252.)

SUPPLEMENT C.—CREDITS AGAINST TAX.

SECTION 131.—TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF UNITED STATES.

ARTICLE 131-8: Limitations on credit for foreign taxes.

REVENUE ACT OF 1938.

Inclusion of untaxed income in numerator of credit-limiting fraction prescribed in section 131(b). (See G. C. M. 22556, page 310.)

SUPPLEMENT G.—INSURANCE COMPANIES.

SECTION 204(b).—INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL: DEFINITION OF INCOME, ETC.

ARTICLE 204(b)-1: Gross income of insurance companies other than life or mutual.

REVENUE ACT OF 1938.

Reserves required by State authority with respect to noncancelable health and accident polices. (See G. C. M. 22503, page 265.)

SUPPLEMENT H.—NONRESIDENT ALIEN INDIVIDUALS.

SECTION 212.—GROSS INCOME.

ARTICLE 212–2: Exclusion of earnings of foreign ships from gross income.

REVENUE ACT OF 1938.

Panama, equivalent exemption provisions of sections 212(b) and 231(d) of the Revenue Act of 1938. (See I. T. 3465, page 268.)

SUPPLEMENT I.—FOREIGN CORPORATIONS.

SECTION 231.—TAX ON FOREIGN CORPORATIONS.

ARTICLE 231–3: Exclusion of earnings of foreign ships from gross income.

REVENUE ACT OF 1938.

Panama, equivalent exemption provisions of sections 212(b) and 231(d) of the Revenue Act of 1938. (See I. T. 3465, page 268.)

INCOME TAX RULINGS.—PART II.

REVENUE ACTS OF 1937 AND 1936.

SUBTITLE B.—GENERAL PROVISIONS.

PART II.—COMPUTATION OF NET INCOME.

SECTION 22(c).—GROSS INCOME: INVENTORIES.

ARTICLE 22(c)-8: Inventories of retail merchants.

REVENUE ACT OF 1936.

Regulations 94, amended. (See T. D. 5048, page 200.)

SECTION 23(a).—DEDUCTIONS FROM GROSS INCOME: EXPENSES.

ARTICLE 23(a)-1: Business expenses.

REVENUE ACT OF 1936.

Expenses incurred in production of taxable income. (See I. T. 3452, page 205.)

SECTION 23(c).—DEDUCTIONS FROM GROSS INCOME: TAXES GENERALLY.

ARTICLE 23(c)-1: Taxes. 1941-19-10706
G. C. M. 22613

REVENUE ACT OF 1936.

The decision in *Commissioner* v. *Rust's Estate et al.* (116 Fed. (2d), 636), relating to real property taxes in the District of Columbia, will not be given general application, but will be applied only in cases involving such real property taxes. Furthermore, the decision will be applied only in those cases where, as in the Rust case, there is an agreement between the buyer and seller adjusting the taxes to the date of sale.

An opinion is requested as to the extent of the application of the decision of the Circuit Court of Appeals for the Fourth Circuit in *Commissioner* v. *Rust's Estate et al.* (116 Fed. (2d), 636, Ct. D. 1508, page 302, this Bulletin), relating to the deduction for Federal income tax purposes of District of Columbia real property taxes in certain cases.

It was held in the Rust case that under the tax laws of the District of Columbia a lien for real property taxes does not arise until there is a delinquency and, accordingly, that one who purchased real estate subsequent to the date of assessment of real property taxes and paid the second semiannual installment of such taxes when it

became due could, for Federal income tax purposes, deduct such payment from gross income. The decision is based upon the ground that the taxes paid may be regarded as a burden imposed upon the purchaser by reason of his ownership of the property at the time the taxes fell due, and were, therefore, his taxes rather than the taxes of the previous owner. The court stated that, with respect to real property held as an investment, taxes are perforce treated as a current expense to be offset against current income, and that no part of the second installment of the taxes in the present case could be fairly allotted to the seller. The court took notice of the agreement between the parties by which the taxes were adjusted to the date of sale.

The court cited *Lifson et al.* v. *Commissioner* (98 Fed. (2d), 508, Ct. D. 1409, C. B. 1939-2, 198) and *Commissioner* v. *Plestcheeff* (100 Fed. (2d), 62, Ct. D. 1410, C. B. 1939-2, 200), in which cases it was held that the deduction for real property taxes in the States of Minnesota and Washington, respectively, is limited to the person who owns the realty at the time the lien for the taxes attaches. The decisions in the Lifson and Plestcheeff cases are contrary to the Bureau's position that, generally, State property taxes accrue on the date as of which the assessment is made (G. C. M. 15305, C. B. XIV-2, 80 (1935)), and that the owner as of that date is the person entitled to a deduction for such taxes for Federal income tax purposes. Upon the basis of the Lifson and Plestcheeff decisions, however, the Bureau changed its position as to the accrual of real property taxes in the States of Minnesota and Washington, but held that such decisions do not affect existing rulings as to the accrual dates of real property taxes in other States (G. C. M. 21373, C. B. 1939-2, 82).

Consistent with the foregoing, the decision in the Rust case will not be given general application but will be applied only in cases involving District of Columbia real property taxes. Furthermore, the decision will be applied only in those cases where, as in the Rust case, there is an agreement between the buyer and seller adjusting the taxes to the date of sale.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

ARTICLE 23(c)-1: Taxes. 1941-19-10707
Ct. D. 1508

INCOME TAX—REVENUE ACT OF 1936—DECISION OF COURT.

1. DEDUCTION—TAXES PAID OR ACCRUED WITHIN TAXABLE YEAR—AGREEMENT BETWEEN SELLER AND PURCHASER AS TO TAX PAYMENT—LIEN UPON REAL PROPERTY—DISTRICT OF COLUMBIA LAW.

The decedent in September, 1935, purchased real estate situated in the District of Columbia against which taxes for the fiscal year ending June 30, 1936, had been assessed in the name of the former owner in July, 1935, payable in September and March following. In March, 1936, the decedent paid the second semiannual installment of such taxes in accordance with an agreement with the seller that the taxes for the current fiscal year should be adjusted to the date of sale. His books were kept on a cash receipts and disbursements basis, and the taxes paid were not capitalized on his accounts as part of the cost of the property. *Held:* That the decedent was en-

titled to a deduction from 1936 gross income, under the provisions of section 23(c) of the Revenue Act of 1936, for the taxes paid in March, 1936. Such taxes may be regarded as a burden imposed upon the decedent by reason of his ownership of the property when the taxes fell due and were therefore his taxes rather than the taxes of the previous owner. Under the law of the District of Columbia the assessment of real estate taxes does not create a personal liability but only a charge upon the land, and a lien for such taxes does not arise prior to the occurrence of a delinquency.

2. DECISION AFFIRMED.

Decision of the United States Board of Tax Appeals (1940) (41 B. T. A., 832) affirmed.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

Commissioner of Internal Revenue, petitioner, v. *Estate of H. L. Rust, Deceased, H. L. Rust, Jr., and Benjamin S. Minor, Executors, respondents.*[1]

[116 Fed. (2d), 636.]

On petition to review the decision of the United States Board of Tax Appeals.

Before PARKER, SOPER, and DOBIE, Circuit Judges.

[December 18, 1940.]

OPINION.

SOPER, Circuit Judge: The Commissioner of Internal Revenue petitions for a review of a decision of the United States Board of Tax Appeals wherein it was held that the taxpayer, now deceased, was entitled to a deduction from gross income on account of the payment on March 31, 1936, of a semiannual installment of taxes for the fiscal year ending June 30, 1936, on real estate in Washington, D. C. The taxes had been assessed in 1935, prior to the taxpayer's acquisition of the property, but were not payable until March, 1936, after the purchase had been consummated. Income taxes for the calendar year 1936 are involved; and the question is whether the real estate taxes paid as aforesaid may be regarded as a burden imposed upon the taxpayer by reason of his ownership of the property when the taxes fell due and were therefore his taxes rather than the taxes of the previous owner.

Taxes were assessed against the property on or before July 1, 1935, under the statutes of the District of Columbia, for the fiscal year then beginning. On July 19, 1935, the tax rate was fixed by the Commissioners of the District and the amount of the tax was determined to be $14,883.34, which was payable in two equal installments of $7,441.67 in September, 1935, and March, 1936, respectively.

On July 1, 1935, and for a number of years prior thereto, the property, which is located at 2101 Connecticut Avenue NW., stood on the tax rolls in the name of the prior owner. On September 17, 1935, it was purchased by the taxpayer at a mortgage foreclosure sale for $275,000, subject to a mortgage of $725,000. Under the terms of the contract of sale the taxes for the current fiscal year, none of which had been paid, were adjusted to the date of sale; and the taxpayer was credited with $3,142.10, representing the portion of the taxes allocable to the period between July 1 and September 17, 1935. The taxpayer paid the first installment of taxes on September 28, 1935, and the second installment on March 31, 1936; but only the second installment is involved in this controversy. The taxes thus paid were not capitalized on the accounts of the taxpayer as part of the cost of the property. He kept his books on a cash receipts and disbursements basis, and claimed a deduction for the second installment in his tax return for the year 1936; but it was disallowed by the Commissioner. On review the Board held that the amount in dispute was properly deductible as "taxes paid" by the taxpayer in the taxable year for the period during which he was the owner.

The relevant Federal statute is section 23(c) of the Revenue Act of 1936 (49 Stat., 1659), which allows a deduction from gross income of "taxes paid or accrued within the taxable year," with certain exceptions not here material.

[1] See G. C. M. 22613, page 301, this Bulletin.

Treasury Regulations 94, promulgated under the Revenue Act of 1936, article 34(c)–1, provide that in general taxes are deductible only by the person upon whom they are imposed.

The tax laws of the District of Columbia are also relevant, since they determine such questions as the incidents of the assessment and of the tax lien upon the property and the personal liability, if any, of the owner for the taxes. (*Walsh-McGuire Co.* v. *Commissioner*, 6 Cir., 97 Fed. (2d), 983; *Commissioner* v. *Plestcheeff*, 9 Cir., 100 Fed. (2d), 62 [Ct. D. 1410, C. B. 1939–2, 200]; *Shotwell* v. *Moore*, 129 U. S., 590, 598; Paul Selected Studied in Federal Taxation, Second Series, pages 23–24.) These statutes are found in Title 20 of the Code of the District of Columbia, 1929. The fiscal year for the District commences on the 1st day of July of each year (section 621). A levy is made for each and every fiscal year of a tax upon real and personal property subject to taxation in the District at a rate fixed annually by the Commissioners (section 681). The assessment is made in the name of the owner with exceptions not here material (section 696). The assessment and valuation of real property are made annually (section 697), the valuation as nearly as practicable on the first Monday of June, and the assessment on or prior to July 1 (sections 700–705). Real estate and personal property taxes are payable in semiannual installments in the months of September and March, with penalties for delinquency, except as to taxes on family dwellings which may be paid quarterly (section 758). Provisions are made for the sale of real estate for delinquent taxes (sections 791–801). The assessor is directed to prepare a list of all taxes on real property which are levied and in arrears on the 1st day of July of each year, and the Commissioners of the District are directed to sell the same if the taxes, together with penalties and costs, shall not be paid prior to the day fixed for sale. If no bid is received sufficient to pay the amount due with penalties and costs, the collector is directed to bid such amount and purchase the property from the District. Provision is also made for the issuance to the purchaser of a certificate of sale and finally a deed if within two years from the date of sale the property is not redeemed by the owner. It is then provided in section 793 "that failure on the part of the District from any cause whatsoever to enforce the lien acquired aforesaid shall not release the property from any tax whatsoever that may be due the District." Section 800 also refers to real estate sold for nonpayment of taxes and bought in by the District, and authorizes the Commissioners, after the lapse of two years, to apply to the Supreme Court of the District "for the purpose of enforcing such tax lien by the said District of Columbia on the aforesaid property."

It was under these statutes that the taxes on the property purchased by the taxpayer were assessed in the name of the former owner on July 1, 1935, for the ensuing fiscal year. No personal liability on the part of the former owner, however, arose from this action, since under the decisions in the District of Columbia the assessment of real estate taxes does not create a personal liability, but only a charge upon the land. (*Tumulty* v. *District of Columbia*, 102 Fed. (2d), 254.) Nor did any tax lien attach to the land by reason of the assessment. A lien for taxes on real estate is a creature of statute, and attaches only when the legislature prescribes. (*Ervin* v. *State*, 5 Cir., 80 Fed. (2d), 432; *Commissioner* v. *Plestcheeff*, 9 Cir., 100 Fed. (2d), 62.) Since no reference is made in the statute to a lien for taxes except in connection with taxes in arrears, it is a reasonable interpretation that the lien does not arise prior to the occurrence of a delinquency. This is nonetheless true even though the taxes in question may have been in some sense a charge upon the land under the statutes of the District of Columbia. Quite frequently, as the decisions cited in this opinion show, the State tax law provides that the tax lien shall attach after the assessment is levied.

It is of course necessary for the taxpayer in the pending case to show that he comes within the terms of the income tax statute allowing the deduction, for "the statutes pertaining to the determination of taxable income have disclosed a general purpose to confine allowable losses to the taxpayer sustaining them, i. e., to treat them as personal to him and not transferable to or usable by another." (*New Colonial Co.* v. *Helvering*, 292 U. S., 435, 440 [Ct. D. 841, C. B. XIII–1, 194 (1934)]; *Colston* v. *Burnet*, C. A. D. C., 59 Fed. (2d), 867.) The question is whether the taxpayer has met this requirement.

The taxes under consideration were not the personal obligation of either the buyer or the seller of the property; but they, nevertheless, fell within the terms of the statute as a deductible item in the computation of taxable income. Whether

or not the deduction could lawfully be taken by the seller, or by the buyer, or partly by one and partly by the other, are questions which should be answered by ascertaining upon whom rests the obligation under the State law to pay the taxes, having in mind the practicalities of the situation. Taxes upon real estate constitute an ever recurring burden; and when, as in this case, the property is held as an investment, they are perforce treated as a current expense to be offset against current income. The provision of the agreement of sale that the taxes should be adjusted to the date of sale was therefore natural and proper, since it allotted to each party a part of the burden proportionate to the period during which he possessed the property and enjoyed the income. Such an arrangement between buyer and seller is typical, and it would be in accord with the facts even if prior to the sale the tax has not only been assessed but has given rise to a lien. The apportionment of the tax was clearly correct in the transaction under discussion, since no part of the second installment of the tax could be fairly allotted to the seller and no part of it was collectible by the District during his period of ownership. The burden of paying this installment was an obligation which passed to the taxpayer with the ownership, in much the same fashion that the benefit of certain covenants is held to run with the land in the law of property; and the burden of the tax rested upon the taxpayer in a very real sense, for a delinquency would have been followed by a forced sale by the tax authorities.

The opposing theory advanced by the Commissioner is that in the case of a sale of property, a tax already assessed for the current year can not be treated by the buyer as an item of current disbursement to be balanced against current income, but becomes a capital item which is added to the purchase price if previously paid by the seller, or subtracted from the purchase price if unpaid at the time of the sale; and, therefore, the tax is not a burden upon the buyer even if he subsequently pays it, because he has already been compensated by the seller. But this theory is not in accord with the actualities of the ordinary case. The whole tax is not added to or subtracted from the purchase price in a sale during the local tax year, but each party is considered as owing a part of the tax proportionate to his period of ownership. In stating the final account of sale, a sum representing the apportionment may for convenience appear as a debit or credit upon the purchase price, but it is not a part thereof and is not so considered. Furthermore, the Commissioner's theory does violence to the purpose of the income tax statutes that items of income shall be accounted for in annual periods. Clearly this purpose will not be served if the constantly recurring burden of the tax is refused recognition as an item of current expense and is placed in the category of a capital expense to be reckoned with under the income tax statutes only in the event of sale at some future date.

The Commissioner's theory certainly does not fit the facts of the pending case. The second installment of the tax did not become due until March, 1936, six months after the sale. It was obvious at the time of sale that the buyer would meanwhile have the enjoyment of the property, and the impending tax burden could not in fact have influenced or entered into the price paid for the property. It would be as plausible to say that the tax for the fiscal year beginning July 1, 1936, or any succeeding year, represented a capital rather than a current expense on the part of the buyer. The Board was correct in deciding that the taxpayer in paying the installment of the tax in question was bearing a burden imposed upon him by reason of his ownership of the property.

The cases in the Board of Tax Appeals turn upon the view that when the tax has been assessed, and is fixed as a lien upon the property, it becomes the personal liability of the owner who is then permitted to accrue it as a liability. Sometimes the local statutes expressly provide that the tax when assessed shall become a personal liability of the owner of the property. In either case, in the view of the Board, the tax is not a burden imposed upon a subsequent purchaser, and if he pays it, it is, so far as he is concerned, a part of the purchase price. He can not claim a deduction because he is not paying his taxes but the taxes of another. (*California Sanitary Co., Ltd.*, v. *Commissioner*, 32 B. T. A., 122; *First Bond & Mortgage Co.* v. *Commissioner*, 27 B. T. A., 430; *Leamington Hotel Co.* v. *Commissioner*, 26 B. T. A., 1004; *Grand Hotel Co.* v. *Commissioner*, 21 B. T. A., 890; *John Hancock Mutual Life Ins. Co.* v. *Commissioner*, 10 B. T. A., 736.) The courts have adopted this view in cases where the local statutes impose a lien upon the property which arises before the property is sold, and this is the holding even though the statutes do not impose a personal obligation upon the owner. (See *Helvering* v. *Missouri State Life Ins. Co.*, 8 Cir., 78 Fed. (2d), 778; *Merchants Bank Bldg. Co.* v. *Helvering*,

8 Cir., 84 Fed. (2d), 478 [Ct. D. 1189, C. B. 1937-1, 189]; *Lifson* v. *Commissioner*, 8 Cir., 98 Fed. (2d), 508 [Ct. D. 1409, C. B. 1939-2, 198]; *Walsh-McGuire Co.* v. *Commissioner*, 6 Cir., 97 Fed. (2d), 983.)

There may seem to be little distinction between the imposition of a statutory lien and the levy of an assessment which is certain to eventuate in a charge against the property. But it is obvious that there must be some point of time when the specific lien, as distinguished from the ever imminent shadow of the tax burden, attaches to the property, and the courts have not been willing to extend the rule to embrace cases where the assessment has been levied, but the lien has not been created before the day of sale. Thus, in *Commissioner* v. *Plestcheeff* (9 Cir., 100 Fed. (2d), 62), the right to the deduction was held to be dependent upon the date when the lien for taxes attached.

In *Commissioner* v. *Coward* (3 Cir., 110 Fed. (2d), 725 [Ct. D. 1458, C. B. 1940-1, 123]), where there was no lien prior to the sale and no personal liability on the part of the prior owner, it was suggested that the Commissioner's argument was "founded on precedent rather than on principle." The court said (page 727):

"We must determine whether a given payment is a forced contribution to the expense of government, or whether it is something else—a voluntary capital expenditure, for example. Its solution must lie in a close analysis of the transaction of payment. It can not, in our judgment, be solved by any rule of thumb that a property owner's payment is not one of a tax on his property because a prior owner (on the accrual basis) might have been permitted to accrue it. For that permission to accrue may depend on technical exigencies of accounting utterly foreign to the later owner's economic position in actually making the payment. * * *

"* * * Where, on the other hand, the tax payment falls into neither of these two categories—where it neither discharges (by contract, express or implied) the personal liability of another, nor what was originally a tax lien on another's property—the deduction has been permitted (*Commissioner* v. *Plestcheeff*, 9 Cir., 100 Fed. (2d), 62)."

This decision was somewhat simplified by a local statute which provided that in the absence of an express agreement to the contrary, the buyer of real estate may hold the seller liable for such proportion of the current year's taxes as the time between January 1 and the date of the deed bears to the full calendar year. It was the view of the court that although the property had been assessed prior to the sale, this did not mean, under the New Jersey statutes, that the tax resulting from that assessment was to be borne by the seller. The court said (page 728):

"It is always borne by the land in the first instance. But as between buyer and seller it is apportioned on the basis of the calendar year. In other words, it is considered fair that the owner of land in any given year shall be called upon to contribute to the year's revenues only a sum commensurate with the length of time the land has been held in that year—except, of course, in the rare case of the prior owner's insolvency. Such a contribution is, in our judgment, a tax in every sense of the word."

In *Carondelet Bldg. Co.* v. *Fontenot* (5 Cir., 111 Fed. (2d), 267), the assessment on the property occurred prior and the tax lien attached subsequent to the taxpayer's purchase. The taxpayer was on an accrual basis and sought a deduction for the taxes accruing between the date of the purchase and the end of its fiscal year, which did not coincide with the tax year of the State. The Commissioner disallowed the deduction on the theory that the whole tax accrued when the assessment was made prior to the transfer. The local statutes imposed no personal liability upon the taxpayer. The court held for the taxpayer, saying that as a matter of practical business, the taxpayer was entitled to prorate the taxes since it owned the building to rent out, and expected to pay the taxes as a fixed charge. Emphasis was placed upon the provisions of the income tax statutes, and of the regulations which require that deductions shall be taken in accordance with the method of accounting under which the net income is computed, and that the computation shall be made in such manner as clearly reflects the income. It was held that there was no rule of law which required the taxes to be accrued for income tax purposes when the assessment was made. This decision not only rejected the contention that the owner at the time of the assessment was alone entitled to take the deduction, but also recognized the right of the taxpayer to apportion the taxes between two consecutive fiscal years.

These later decisions, as well as the decision of the Board in the pending case, view realistically the situation which ordinarily confronts the parties to a sale of real estate when they approach the disposition of the tax burden for the year of sale. Whether this attitude should not also be taken in the event of a sale after personal liability on the part of the seller or a statutory lien for the tax has arisen, we have no occasion to decide. The question here is whether, in the absence of personal liability and of a lien, the parties may agree to apportion a tax, not yet payable, to their respective periods of ownership. We think that they may; because such an agreement merely assigns to each party the obligation to bear his own burden of taxation.

The decision of the Board is affirmed.

SECTION 23(m).—DEDUCTIONS FROM GROSS INCOME: DEPLETION.

ARTICLE 23(m)-1: Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.

REVENUE ACT OF 1936.

Status of oil and gas leasing transactions. (See G. C. M. 22730, page 214.)

ARTICLE 23(m)-9: Determination of mineral contents of mines and of oil or gas wells.

REVENUE ACT OF 1936.

Regulations 94, amended. (See T. D. 5054, page 227.)

PART IV.—ACCOUNTING PERIODS AND METHODS OF ACCOUNTING.

SECTION 41.—GENERAL RULE.

ARTICLE 41-2: Bases of computation and changes in accounting methods.

REVENUE ACT OF 1936.

Income from long-term contracts—cash receipts and disbursements method. (See G. C. M. 22682, below.)

SECTION 42.—PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

ARTICLE 42-4: Long-term contracts. 1941-21-10720
(Also Section 41, Article 41-2.) G. C. M. 22682

REVENUE ACT OF 1936.

Income derived by the M Company from long-term contracts is not required to be determined upon either the basis of percentage of completion or upon the completed contract basis. It is permissible in proper cases that income derived from such contracts be determined upon the basis of the cash receipts and disbursements method of accounting.

An opinion is requested whether it is mandatory that the M Company's taxable income for the years 1936 and 1937, in so far as such income is derived from long-term contracts, be determined upon either the basis of percentage of completion or upon the completed contract basis, or whether it is permissible that income derived from such contracts be determined upon the basis of the cash receipts and disbursements method of accounting.

The taxpayer, the M Company, was organized in 1931. It is engaged in the general contracting business, and a substantial part thereof consists of long-term contracts as that term is defined in article 42-4, Regulations 94. From 1931 through 1937, the taxpayer has consistently kept its books and filed its returns upon the basis of the cash receipts and disbursements method of accounting. The question has arisen, involving the years 1936 and 1937, as to whether the taxpayer should be required to use the completed contract basis as provided in paragraph (*b*) of article 42-4 of Regulations 94. The position that it should be required to report on such basis is predicated primarily upon two conclusions: (1) that one of the two methods prescribed in article 42-4 is mandatory; and (2) that the percentage of completion method can not be applied for lack of necessary records and, therefore, the completed contract basis must be applied.

Section 41, Revenue Act of 1936, reads in part as follows:

> 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. * * *

Article 41-2, Regulations 94, reads in part as follows:

> A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this article, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see articles 22(c)-1 to 22(c)-8); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see article 42-4); * * *.

Section 42, Revenue Act of 1936, reads in part as follows:

> 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. * * *

Article 42-4, Regulations 94, reads in part as follows:

> Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this article the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year. Persons whose income is derived in whole or

in part from such contracts *may*, as to such income, prepare their returns upon either of the following bases:

* * * * * * *

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

Section 41, supra, provides that net income shall be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed in keeping the books of such taxpayer. Article 41-2, supra, provides that a taxpayer who desires to change from the cash or accrual method to the long-term contract method, or vice versa, must secure the consent of the Commissioner. In providing for the use of the percentage of completion method or the completed contract method, article 42-4, supra, uses the word "may," and is, therefore, permissive and not mandatory. Also, the first sentence of the article contains the inference that the taxpayer's regular method of accounting—accrual or cash basis—may be permissible. Furthermore, the provision in article 42-4, supra, to the effect that the taxpayer may change his method of accounting to accord with paragraph (*a*) or (*b*) only after permission is secured from the Commissioner is inconsistent with the conclusion that article 42-4, supra, was intended to be mandatory.

It is pointed out that the regulations in effect prior to 1932 specifically recognized the propriety of all three methods of accounting (cash, accrual, or long-term contract method) in the following language:

* * * Where a taxpayer has filed his return in accordance with the method of accounting regularly employed by him in keeping his books and such method clearly reflects the income, he will not be required to change to either of the methods above set forth. If a taxpayer desires to change his method of accounting in accordance with paragraphs (*a*) and (*b*) of this article, a statement showing the composition of all items appearing upon his balance sheet and used in connection with the method of accounting formerly employed by him, should accompany his return. (See article 334, Regulations 74.)

The first sentence quoted above was omitted from article 334, Regulations 77, relating to the Revenue Act of 1932. (See also later regulations.) However, it is the opinion of this office that the omission was not for the purpose of making one of the long-term contract methods of reporting income mandatory in the case of income from long-term contracts. It seems obvious that the sentence was omitted because its equivalent was to be found elsewhere in the statute and regulations. Furthermore, in actual practice the Bureau has not considered the regulations as requiring a taxpayer receiving income from long-term contracts to report that income upon the basis of one of the long-term contract methods.

Accordingly, it is the opinion of this office that it is not mandatory that the income of the M Company for the years 1936 and 1937, in so far as such income is derived from long-term contracts, be determined upon either the basis of percentage of completion or upon the completed contract basis; and that it is permissible in proper cases that income derived from such contracts be determined upon the basis of the cash receipts and disbursements method of accounting.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

SUBTITLE C.—SUPPLEMENTAL PROVISIONS.

SUPPLEMENT B.—COMPUTATION OF NET INCOME.

SECTION 113(a).—ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS: BASIS (UNADJUSTED) OF PROPERTY.

REVENUE ACT OF 1936.

Sale of securities received by legatees under testamentary trust. (See Ct. D. 1516, page 371.)

SECTION 116.—EXCLUSIONS FROM GROSS INCOME.

REVENUE ACT OF 1936.

Meaning of term "coastwise," as used in G. C. M. 22383 (C. B. 1940-2, 227). (See I. T. 3461, page 251.)

REVENUE ACT OF 1936.

Wages of seamen employed on vessels engaged in coastwise trade. (See I. T. 3467, page 4.)

SUPPLEMENT C.—CREDITS AGAINST TAX.

SECTION 131.—TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF UNITED STATES.

ARTICLE 131-8: Limitations on credit for foreign taxes.

REVENUE ACT OF 1936.

Inclusion of untaxed income in numerator of credit-limiting fraction prescribed in section 131(b.) (See G. C. M. 22556, below.)

ARTICLE 131-8: Limitations on credit for foreign taxes. 1941-11-10637
G. C. M. 22556

REVENUE ACTS OF 1932, 1934, 1936, AND 1938.

To the extent that a taxpayer's income derived from sources without the United States is properly includible as a part of total net income for Federal income tax purposes, such foreign income should be included in the numerator of the credit-limiting fraction provided by section 131(b) of the Revenue Acts of 1932, 1934, 1936, and 1938, regardless of whether such income was taxed by the foreign country in which such income was realized.

An opinion is requested whether in determining the limitation on foreign tax credits under the provisions of section 131(b) of the Revenue Acts of 1932, 1934, 1936, and 1938 there should be included

in the numerator of the credit-limiting fraction, provided by that section, income (hereinafter described) from sources within foreign countries, which income has not been taxed in those countries.

Section 131(b) of the Revenue Act of 1932 (reenacted without change in the Revenue Acts of 1934, 1936, and 1938) provides as follows:

> (b) LIMIT ON CREDIT.—The amount of the credit taken under this section shall be subject to each of the following limitations:
>
> (1) The amount of the credit in respect of the tax paid or accrued to any country shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's net income from sources within such country bears to his entire net income for the same taxable year; and
>
> (2) The total amount of the credit shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's net income from sources without the United States bears to his entire net income for the same taxable year.

Although the underlying purpose which Congress had in mind in providing for a credit for income, war-profits, and excess-profits taxes paid or accrued to a foreign country was to avoid double taxation which would result if the same income were taxed both in the foreign country of its origin and in the United States (*Burnet* v. *Chicago Portrait Co.*, 285 U. S., 1, Ct. D. 463, C. B. XI–1, 286 (1932); *Hubbard* v. *United States*, 17 Fed. Supp., 93, Ct. D. 1224, C. B. 1937-1, 259, certiorari denied, 300 U. S., 666), the language used by Congress is clear and, until modified, must be followed. In providing for the fraction to be used in determining the limit upon credit for foreign taxes, the words "net income" are used. These words can not fairly be construed to have a meaning when used in section 131(b), supra, different from the well-established meaning which they have when used in other sections of the Revenue Acts. Therefore, the words "net income," as used in section 131(b), have been construed to refer to "net income within the meaning of the United States income tax law." (G. C. M. 21432, C. B. 1939–2, 234; *Burk Bros.* v. *Commissioner*, 20 B. T. A., 657.) No authority exists for interpreting "net income from sources within such country" as "net income from sources within such country upon which a tax has been paid to such country."

Inquiry has been made as to whether four categories of income (described below) received by a taxpayer from sources in foreign countries are to be included in the numerator of the credit-limiting fraction provided by section 131(b), supra. Upon the basis of the foregoing, each category will be discussed separately.

(*a*) Where such specific income is taxable under the laws of the foreign government but not taxed for the reason that it has not been disclosed to such government.

Receipts which constitute a part of the taxpayer's net income within the concept of the United States income tax law are includible in the numerator of the credit-limiting fraction regardless of the disclosure or nondisclosure of such receipts to the government of the foreign country from sources in which such receipts are derived.

(*b*) Where such specific income is not taxable under the laws of the foreign government but is not specifically tax exempt. The laws of the foreign government did not tax profit realized on sales of personal property by a foreign corporation that had no established place of business therein. This income would have been taxable if an established place of business had been maintained.

It appears that the taxpayer in question purchased merchandise from its French and German subsidiaries and resold the same to its English and other foreign subsidiaries. The contracts were made by cable, the offers to buy and sell being received and accepted by the taxpayer at its office in the United States. The merchandise was shipped c. i. f. directly by the selling subsidiary to the purchasing subsidiary by common carrier. It appears that since the taxpayer did not maintain any office or representative in Germany or France gains realized in those countries by reason of the aforementioned sales were not subject to French and German income taxes. The income so realized by the taxpayer clearly constitutes income from sources without the United States.

Since the above-mentioned income is from sources without the United States and is part of the taxpayer's net income for Federal income tax purposes, it follows that such income is properly includible in the numerator of the credit-limiting fraction.

(*c*) Where such specific income is not taxable under the laws of the foreign government because of the fact that under those laws no such income existed. This issue involves the sale of the currency of the foreign government, the United States tax basis of the currency sold being the value thereof in terms of United States dollars at the time of receipt, the proceeds of the sale also being expressed in terms of United States dollars.

Since the gain derived from the sale of foreign currency is recognized as being part of the taxpayer's net income within the concept of the Federal income tax law, such income is properly includible in the numerator of the credit-limiting fraction regardless of the recognition or nonrecognition of such receipts as income by a foreign country.

(*d*) Where such specific income of a United States corporation is not taxable because of a treaty with the foreign government. The purpose of the treaty was to avoid double taxation on certain designated classes of income.

No facts have been presented with respect to the type of income which is claimed to be nontaxable by France under the convention and protocol between France and the United States. (See T. D. 4746, C. B. 1937-2, 64.) The fair inference to be drawn from the record before this office is that the taxpayer maintained no permanent establishment in France and, therefore, was not liable for French taxes upon its income derived from that country even in the absence of any agreement between France and the United States. If, in any event, the gain derived in the foreign country constitutes part of the taxpayer's net income for the purposes of the United States income tax, such gain is includible in the numerator of the credit-limiting fraction even when the gain is nontaxable under the law or treaty commitments of such foreign country.

In view of the foregoing, it is the opinion of this office that to the extent that the taxpayer's income derived from sources without the United States is properly includible as a part of net income for Federal income tax purposes such foreign income should be included in the numerator of the credit-limiting fraction provided by section 131(b) of the Revenue Acts of 1932, 1934, 1936, and 1938, regardless of whether such income was taxed by the foreign country in which such income was realized.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

SUPPLEMENT G.—INSURANCE COMPANIES.

SECTION 204(b).—INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL: DEFINITION OF INCOME, ETC.

ARTICLE 204(b)–1: Gross income of insurance companies other than life or mutual.

REVENUE ACT OF 1936.

Reserves required by State authority with respect to noncancelable health and accident policies. (See G. C. M. 22503, page 265.)

SUPPLEMENT H.—NONRESIDENT ALIEN INDIVIDUALS.

SECTION 212.—GROSS INCOME.

ARTICLE 212–2: Exclusion of earnings of foreign ships from gross income.

REVENUE ACT OF 1936.

Panama, equivalent exemption provisions of sections 212(b) and 231(d) of the Revenue Act of 1936. (See I. T. 3465, page 268.)

SUPPLEMENT I.—FOREIGN CORPORATIONS.

SECTION 231.—TAX ON FOREIGN CORPORATIONS.

ARTICLE 231–4: Exclusion of earnings of foreign ships from gross income.

REVENUE ACT OF 1936.

Panama, equivalent exemption provisions of sections 212(b) and 231(d) of the Revenue Act of 1936. (See I. T. 3465, page 268.)

INCOME TAX RULINGS.—PART III.

REVENUE ACTS OF 1935 AND 1934 OR PRIOR ACTS.

SUBTITLE B.—GENERAL PROVISIONS.

PART II.—COMPUTATION OF NET INCOME.

SECTION 22(a).—GROSS INCOME: GENERAL DEFINITION.

ARTICLE 22(a)-1: What included in gross income. 1941-13-10662
Ct. D. 1497

INCOME TAX—REVENUE ACT OF 1934—DECISION OF SUPREME COURT.

1. CIRCUIT COURT OF APPEALS—POWER TO CONSIDER QUESTION OF LAW NOT RAISED BEFORE BOARD OF TAX APPEALS—APPLICABILITY OF SECTION DEFINING GROSS INCOME—REMAND TO BOARD OF TAX APPEALS.

For the reasons set out in the decision in *Hormel* v. *Helvering* [Ct. D. 1498, page 315, this Bulletin], the circuit court of appeals was in error in its conclusion that it could not consider the applicability of section 22(a) of the Revenue Act of 1934 to the facts in this case on the ground that the issue was not presented before the Board of Tax Appeals. Under the circumstances of the case, the petitioner is entitled to introduce additional evidence upon remand of the case to the Board.

2. DECISION REVERSED.

Decision of the United States Circuit Court of Appeals, Third Circuit (1940) (114 Fed. (2d), 452), affirming memorandum opinion of the Board of Tax Appeals, reversed.

SUPREME COURT OF THE UNITED STATES.

Guy T. Helvering, Commissioner of Internal Revenue, petitioner, v. *O. G. Richter.*

[61 S. Ct., 723.]

On writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit.

[March 17, 1941.]

OPINION.

Mr. Justice BLACK delivered the opinion of the Court.

Because the decision below (114 Fed. (2d), 452) was in conflict with that of the Circuit Court of Appeals for the Eighth Circuit in *Helvering* v. *Hormel* (111 Fed. (2d), 1) affirmed this day, we granted certiorari "limited to the first question presented by the petition for the writ." (311 U. S., —.) The petition stated that question as follows:

"The taxpayer transferred securities to a third party in trust to pay the income to his wife. At the end of five years, or earlier if the beneficiary consented, the securities were to be transferred back to the taxpayer. The Board of Tax Appeals held that the grantor was not taxable with respect to the income from the trust. Two questions are presented:

"1. Whether, by invoking the general gross income provisions of section 22, the Commissioner had so changed the theory of the Government's case on appeal as to preclude the circuit court of appeals from considering the issue.

"2. Whether, on the merits, the trust income was taxable as income of the grantor under section 22."

In view of the limited grant of certiorari, the second question is not before us. On the first question, the circuit court of appeals held that it could not consider the applicability of section 22(a), that being an "issue now for the

first time presented by the Commissioner." The decision of the Board of Tax Appeals, which the circuit court of appeals affirmed, was handed down prior to our decision in *Helvering* v. *Clifford* (309 U. S., 331 [Ct. D. 1444, C. B. 1940–1, 105]). Respondent urges that had he been advised with fair certainty that the Government relied upon section 22(a), he could have introduced additional evidence directed to that issue. For reasons set out in our decision in *Hormel* v. *Helvering* [Ct. D. 1498, below], we are of opinion that the circuit court of appeals was in error in its conclusion, but we are also of opinion that respondent is entitled to introduce additional evidence if he so desires. The judgment is accordingly reversed, with directions to the court below to remand to the Board of Tax Appeals for rehearing in the light of the Clifford case.

Reversed.

ARTICLE 22(a)–1: What included in gross income. 1941–13–10663 Ct. D. 1498

INCOME TAX—REVENUE ACT OF 1934—DECISION OF SUPREME COURT.

1. CIRCUIT COURT OF APPEALS—POWER TO CONSIDER QUESTION OF LAW NOT RAISED BEFORE BOARD OF TAX APPEALS—APPLICABILITY OF SECTION DEFINING GROSS INCOME—REMAND TO BOARD OF TAX APPEALS.

The circuit court of appeals was correct in giving consideration to the applicability of section 22(a) of the Revenue Act of 1934 in determining whether income of certain trusts created by the taxpayer was taxable to him, although that section was not relied upon before the Board of Tax Appeals. The general principle of appellate practice that a reviewing court may not consider questions of law which were neither presented nor passed upon below should not be applied if to do so would defeat rather than promote the ends of justice. Under the circumstances of this case, the petitioner should not be foreclosed from the opportunity to offer evidence before the Board on the issue of the applicability of section 22(a).

2. SHORT-TERM TRUST—INCOME TAXABLE TO GRANTOR.

The taxpayer created three short-term trusts, naming himself and another as trustees, with substantial control over the trust properties and with power in the grantor and his wife to remove the co-trustee at any time. Trust income up to a certain amount was to be paid to the wife as guardian of their three sons, any excess to be paid to the grantor. *Held:* As the record stands, the court below correctly held that the trust income was taxable to the grantor under the principles announced in *Helvering* v. *Clifford* (309 U. S., 331 [Ct. D. 1444, C. B. 1940–1, 105].)

3. CASES DISTINGUISHED.

Helvering v. *Wood* (309 U. S., 344 [Ct. D. 1445, C. B. 1940–1, 162]), *Helvering* v. *Tex-Penn Oil Co.* (300 U. S., 481 [Ct. D. 1220, C. B. 1937–1, 236]), and *General Utilities & Operating Co.* v. *Helvering* (296 U. S., 200 [Ct. D. 1055, C. B. XV–1, 214 (1936)]) distinguished.

4. DECISION AFFIRMED.

Decision of the United States Circuit Court of Appeals, Eighth Circuit (1940) (111 Fed. (2d), 1), reversing decision of the United States Board of Tax Appeals (1939) (39 B. T. A., 244), affirmed.

SUPREME COURT OF THE UNITED STATES.

Jay C. Hormel, petitioner, v. *Guy T. Helvering, Commissioner of Internal Revenue.*

[61 S. Ct., 719.]

On writ of certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

[March 17, 1941.]

OPINION.

Mr. Justice BLACK delivered the opinion of the Court.

The Commissioner of Internal Revenue assessed a deficiency against petitioner for failure to include in his 1934 and 1935 tax returns the income of three separate

trusts declared by him in 1934. Each of the declarations of trust recited that the beneficiaries were "Jay C. Hormel [petitioner himself], and Germaine D. Hormel, his wife, as guardian for their son," a different son being designated by each trust instrument. Each trust estate consisted of shares of stock in Geo. A. Hormel & Co., of which petitioner was an officer. Petitioner named himself and another as co-trustees; all dividends from each trust estate, up to $2,000 a year, were to be paid to petitioner's wife as guardian for the son named in the particular trust instrument, and any excess over $2,000 was to be paid to petitioner; the trusts were to expire automatically after three years, or upon the death of petitioner, or upon the death of the named son, whichever event should occur first; upon expiration of each trust, the entire principal should be the property of petitioner, his legatees, devisees, or heirs; petitioner and his wife (as guardian) had the power to remove petitioner's co-trustee at any time, and to choose a successor; the co-trustees could appoint proxies to exercise voting rights over the shares of stock making up the trust estates, and could sell the securities deposited and substitute others; it was provided that no title to the trust estates should vest in petitioner's wife, as guardian, or in his sons, and it was further provided that the wife and sons should have no power "to sell, transfer, encumber or in any manner anticipate or dispose of any interest in the trust estate"; and, finally, the trust instruments stated that the co-trustees were to be responsible for loss only upon willful and deliberate violations of their duties.

All of the trust income for the years in question was distributed to petitioner's wife as guardian, who reported it to the Federal Government as guardianship income. Petitioner, in his individual returns, did not include it. The Commissioner, taking the position that petition should have included the trust income in his individual returns, assessed a deficiency against him, asserting that the trusts were "revocable" and the income therefore petitioner's within the meaning of section 166 of the Revenue Act of 1934.[1] The Board of Tax Appeals decided against the Commissioner, holding that the income in question was taxable to petitioner neither under section 166 nor 167,[2] the two sections expressly relied on by the Commissioner before the Board. In the circuit court of appeals, the Commissioner abandoned reliance on section 166, urged that the Board was in error as to taxability under section 167, and argued that in any event the income was taxable to petitioner under section 22(a).[3] The taxpayer argued that the applicability of section 22(a) was not open for consideration, inasmuch as that section had not been relied on before the Board. The circuit court of appeals, though agreeing with the Board as to nontaxability under sections 166 and 167, nevertheless ruled that section 22(a) could properly be considered, and held the income taxable to petitioner under that section. Because of a conflict among the circuit courts of appeals on the propriety of considering section 22(a) under these circumstances,[4] we granted certiorari. (311 U. S., —.) Two questions are presented for our decision: First, Was the court below correct in holding that section 22(a) should be considered? Second, If so, was the court below justified in determining that the income of these trusts was taxable to petitioner under section 22(a)?

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[1] Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—

(1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or

(2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, then the income of such part of the trust shall be included in computing the net income of the grantor.

[2] Section 167 reads in part as follows:

"(a) Where any part of the income of a trust—

"(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or

"(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor, * * *."

[3] "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. * * *.

[4] Cf., e. g., *Helvering* v. *Hormel* (111 Fed. (2d), 1) (the decision below), with *Helvering* v. *Richter* (114 Fed. (2d), 452 [Ct. D. 1497, page 314, this Bulletin], reversed this day).

First. Petitioner in effect challenges the power of the circuit court of appeals to pass upon any questions other than those which were directly and squarely presented in the proceedings before the Board of Tax Appeals. That court's authority to review decisions of the Board rests on statutes, which provide in part that the circuit courts of appeals "have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require." (26 U. S. C., section 1141(c)(1) (Supp. 1939).) In general, it is the function of the Board to determine the facts of a tax controversy on issues raised before it and to apply the law to those facts; and it is the function of the reviewing court to decide whether the Board has applied the correct rule of law.[5]

Ordinarily an appellate court does not give consideration to issues not raised below. For our procedural scheme contemplates that parties shall come to issue in the trial forum vested with authority to determine questions of fact. This is essential in order that parties may have the opportunity to offer all the evidence they believe relevant to the issues which the trial tribunal is alone competent to decide; it is equally essential in order that litigants may not be surprised on appeal by final decision there of issues upon which they have had no opportunity to introduce evidence. And the basic reasons which support this general principle applicable to trial courts make it equally desirable that parties should have an opportunity to offer evidence on the general issues involved in the less formal proceedings before administrative agencies entrusted with the responsibility of fact finding. Recognition of this general principle has caused this Court to say on a number of occasions that the reviewing court should pass by, without decision, questions which were not urged before the Board of Tax Appeals. But those cases do not announce an inflexible practice, as indeed they could not without doing violence to the statutes which give to circuit courts of appeals reviewing decisions of the Board of Tax Appeals the power to modify, reverse or remand decisions not in accordance with law "as justice may require." There may always be exceptional cases or particular circumstances which will prompt a reviewing or appellate court, where injustice might otherwise result, to consider questions of law which were neither pressed nor passed upon by the court or administrative agency below. (See *Blair* v. *Oesterlein Machine Co.*, 275 U. S., 220, 225 [T. D. 4120, C. B. VII–1, 181 (1928)].)

Rules of practice and procedure are devised to promote the ends of justice, not to defeat them. A rigid and undeviating judicially declared practice under which courts of review would invariably and under all circumstances decline to consider all questions which had not previously been specifically urged would be out of harmony with this policy. Orderly rules of procedure do not require sacrifice of the rules of fundamental justice. And examination of the cases relied upon by petitioner discloses that this Court, in following in some cases the general principle sought to be invoked here by petitioner, has been careful to point out the circumstances justifying application of the practice in the particular case. Thus, for example, we held in *Helvering* v. *Wood* (309 U. S., 344, 348–349 [Ct. D. 1445, C. B. 1940–1, 162]) that the Government could not present in this Court as a wholly new issue the applicability of section 22(a). But we there especially relied upon the fact that the Government, when the case was before the circuit court of appeals, had made an express waiver of any reliance upon 22(a). In *Helvering* v. *Tex-Penn Oil Co.* (300 U. S., 481, 498 [Ct. D. 1220, C. B. 1937–1, 236]), this Court declined to consider a newly presented question, but pointed out that it had not been raised by the Commissioner either in his notice of tax deficiency, in his appearances before the Board of Tax Appeals or the circuit court of appeals, or in his petition for certiorari to this Court. And in *General Utilities & Operating Co.* v. *Helvering* (296 U. S., 200, 206–207 [Ct. D. 1055, C. B. XV–1, 214 (1936)]), though this Court said that the circuit court of appeals should not have considered a contention not presented to or ruled upon by the Board of Tax Appeals, the statement was buttressed by adding that the circuit court of appeals had "made an inference of fact directly in conflict with

[5] The Board's rulings on questions of law, while not as conclusive as its findings of fact, are nevertheless persuasive, and it is desirable that a reviewing court have the benefit of such rulings. (See *Helvering* v. *Wood*, 309 U. S., 344, 349; *Helvering* v. *Tex-Penn Oil Co.*, 300 U. S., 481, 498.) This is true not only of the Board of Tax Appeals but of other administrative bodies as well. (Cf. *Federal Trade Commission* v. *R. F. Keppel & Bro.*, 291 U. S., 304, 314.)

the stipulation of the parties and the findings, for which we think the record affords no support whatever. To remand the cause for further findings would be futile. The Board could not properly find anything which would assist the Commissioner's cause." The plain implication of that decision was that the cause would have been remanded to the Board of Tax Appeals had the Court considered the newly raised point to be of sufficient merit. These decisions and others like them, while recognizing the desirability and existence of a general practice under which appellate courts confine themselves to the issues raised below, nevertheless do not lose sight of the fact that such appellate practice should not be applied where the obvious result would be a plain miscarriage of justice. Analogous in principle is the philosophy which underlies this Court's decisions with relation to appellate practices in other cases: those in which it has been held that a decision of the Board of Tax Appeals can be supported in the reviewing court on a new theory of law;[6] those which have been remanded because the lower courts failed to give consideration to a phase of the case involving legal theories not presented;[7] and those in which there have been judicial interpretations of existing law after decision below and pending appeal—interpretations which if applied might have materially altered the result.[8] Whether articulated or not, the philosophy underlying the exceptions to the general practice is in accord with the statutory authority given to courts reviewing decisions of the Board of Tax Appeals—decisions not in accordance with law should be modified, reversed or reversed and remanded "as justice may require."

In accordance with this principle, we are of opinion that the court below should have given and properly did give consideration to section 22(a) in determining petitioner's tax liability. The Commissioner urged this point before the circuit court of appeals and has strongly presented it here. At the time the Board of Tax Appeals made its decision in this case, we had not yet handed down our opinion in *Helvering* v. *Clifford* (309 U. S., 331 [Ct. D. 1444, C. B. 1940-1, 105]), in which we held that under section 22(a) the income of certain trusts was taxable to respondent. The circuit court of appeals was of opinion that there were no controlling distinctions between the trusts created by petitioner in this case and those created by Clifford. Here, as there, control over the trusts was completely in the hands of the taxpayer and his wife. For while petitioner's trust instruments showed a co-trustee acting with petitioner, the same instruments also disclosed that such co-trustee could be removed at any time by the joint action of petitioner and his wife. "To hold otherwise [i. e., that petitioner is not subject to the tax] would be to treat the wife as a complete stranger; to let mere formalism obscure the normal consequences of family solidarity; and to force concepts of ownership to be fashioned out of legal niceties which may have little or no significance in such household arrangements."[9] As the record now stands we think the court below correctly concluded that the trust income was taxable to petitioner under the principles announced in the Clifford case. Therefore to apply here the general principle of appellate practice for which petitioner contends would result in permitting him wholly to escape payment of a tax which under the record before us he clearly owes. Thus viewed, this is exactly the type of case where application of the general practice would defeat rather than promote the ends of justice, and the court below was right in so holding.

But the Board of Tax Appeals neither found the facts nor considered the applicability of 22(a) in the light of the Clifford case. Congress has entrusted the Board with exclusive authority to determine disputed facts. Under these circumstances we do not feel that petitioner should be foreclosed from all opportunity to offer evidence before the Board on this issue, however remote may be his chance to take his case out of the Clifford rule.[10] Accordingly, the judgment of the lower court reversing the decision of the Board of Tax Appeals is affirmed, with directions to the Board of Tax Appeals for further proceedings in accordance with this opinion.

It is so ordered.

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[6] E. g., *Helvering* v. *Gowran* (302 U. S., 238, 246 [Ct. D. 1292, C. B. 1938-1, 300]).

[7] E. g., *United States* v. *Shelby Iron Co.* (273 U. S., 571, 579); *United States* v. *Rio Grande Dam & Irrigation Co.* (184 U. S., 416, 423).

[8] E. g., *Vandenbark* v. *Owens-Illinois Glass Co.* (No. 141 this term), and cases there cited.

[9] *Helvering* v. *Clifford* (309 U. S., 331, 336-337).

[10] In this connection petitioner pointed out in his brief before the circuit court of appeals that "If any contention whatsoever had at any time been suggested or considered as to section 22, the matter of the evidence introduced or to be introduced would have required further consideration."

ARTICLE 22(a)-1: What included in gross income. 1941-15-10675
Ct. D. 1502

INCOME TAX—REVENUE ACT OF 1932—DECISION OF SUPREME COURT.

1. GROSS INCOME—CONSIDERATION RECEIVED FOR CANCELLATION OF LEASE—NO REDUCTION ON ACCOUNT OF LOSS OF INCOME EXPECTED TO BE REALIZED.

Taxpayer acquired property by devise from his father in 1928, which property was leased in 1932 for a 15-year term at an annual rental of $25,000. In 1933 the lease was canceled in consideration of a payment to taxpayer of $140,000. *Held:* The amount received by taxpayer in 1933 for cancellation of the lease was not a return of capital but must be regarded as ordinary income and included in gross income as defined in section 22(a) of the Revenue Act of 1932, without regard to the claimed disparity between that amount and the difference between the present value of the unmatured rental payments and the fair rental value of the property for the unexpired period of the lease. Nothing in section 23(e) indicates that Congress intended to allow taxpayer to reduce ordinary income actually received and reported by the amount of income he failed to realize.

2. DECISION AFFIRMED.

Decision of the United States Circuit Court of Appeals, Second Circuit [1940] (112 Fed. (2d), 167), affirming decision of the United States Board of Tax Appeals [1939] (39 B. T. A., 922), affirmed.

SUPREME COURT OF THE UNITED STATES.

Walter M. Hort, petitioner, v. *Commissioner of Internal Revenue, respondent.*
[61 S. Ct., 757.]

On writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[March 31, 1941.]

OPINION.

Mr. Justice MURPHY delivered the opinion of the Court.

We must determine whether the amount petitioner received as consideration for cancellation of a lease of realty in New York City was ordinary gross income as defined in section 22(a) of the Revenue Act of 1932 (47 Stat., 169, 178), and whether, in any event, petitioner sustained a loss through cancellation of the lease which is recognized in section 23(e) of the same Act (47 Stat., 169, 180).

Petitioner acquired the property, a lot and 10-story office building, by devise from his father in 1928. At the time he became owner, the premises were leased to a firm which had sublet the main floor to the Irving Trust Co. In 1927, five years before the head lease expired, the Irving Trust Co. and petitioner's father executed a contract in which the latter agreed to lease the main floor and basement to the former for a term of 15 years at an annual rental of $25,000, the term to commence at the expiration of the head lease.

In 1933, the Irving Trust Co. found it unprofitable to maintain a branch in petitioner's building. After some negotiations, petitioner and the Trust company agreed to cancel the lease in consideration of a payment to petitioner of $140,000. Petitioner did not include this amount in gross income in his income tax return for 1933. On the contrary, he reported a loss of $21,494.75 on the theory that the amount he received as consideration for the cancellation was $21,494.75 less than the difference between the present value of the unmatured rental payments and the fair rental value of the main floor and basement for the unexpired term of the lease. He did not deduct this figure, however, because he reported other losses in excess of gross income.

The Commissioner included the entire $140,000 in gross income, disallowed the asserted loss, made certain other adjustments not material here, and assessed a deficiency. The Board of Tax Appeals affirmed. (39 B. T. A., 922.) The

circuit court of appeals affirmed per curiam on the authority of *Warren Service Corporation* v. *Helvering* (110 Fed. (2d), 723). (112 Fed. (2d), 167.) Because of conflict with *Commissioner* v. *Langwell Real Estate Corporation* (47 Fed. (2d), 841 [Ct. D. 348, C. B. X–1, 361 (1931)]), we granted certiorari limited to the question whether, "in computing net gain or loss for income tax purposes, a taxpayer [can] offset the value of the lease canceled against the consideration received by him for the cancellation." (311 U. S., —.)

Petitioner apparently contends that the amount received for cancellation of the lease was capital rather than ordinary income and that it was therefore subject to sections 101, 111–113, and 117 (47 Stat., 169, 191, 195–202, 207) which govern capital gains and losses. Further, he argues that even if that amount must be reported as ordinary gross income he sustained a loss which section 23(e) authorizes him to deduct. We can not agree.

The amount received by petitioner for cancellation of the lease must be included in his gross income in its entirety. Section 22(a), copied in the margin,[1] expressly defines gross income to include "gains, profits, and income derived from * * * rent, * * * or gains or profits and income from any source whatever." Plainly this definition reached the rent paid prior to cancellation just as it would have embraced subsequent payments if the lease had never been canceled. It would have included a prepayment of the discounted value of unmatured rental payments whether received at the inception of the lease or at any time thereafter. Similarly, it would have extended to the proceeds of a suit to recover damages had the Irving Trust Co. breached the lease instead of concluding a settlement. (Compare *United States* v. *Safety Car Heating Co.*, 297 U. S., 88 [Ct. D. 1073, C. B. XV–1, 294 (1936)]; *Burnet* v. *Sanford*, 282 U. S., 359 [Ct. D. 277, C. B. X–1, 363 (1931)].) That the amount petitioner received resulted from negotiations ending in cancellation of the lease rather than from a suit to enforce it can not alter the fact that basically the payment was merely a substitute for the rent reserved in the lease. So far as the application of section 22(a) is concerned, it is immaterial that petitioner chose to accept an amount less than the strict present value of the unmatured rental payments rather than to engage in litigation, possibly uncertain and expensive.

The consideration received for cancellation of the lease was not a return of capital. We assume that the lease was "property," whatever that signifies abstractly. Presumably the bond in *Helvering* v. *Horst* (311 U. S., 112 [Ct. D. 1472, C. B. 1940–2, 206] and the lease in *Helvering* v. *Bruun* (309 U. S., 461 [Ct. D. 1450, C. B. 1940–1, 112]) were also "property," but the interest coupon in *Horst* and the building in *Bruun* nevertheless were held to constitute items of gross income. Simply because the lease was "property" the amount received for its cancellation was not a return of capital, quite apart from the fact that "property" and "capital" are not necessarily synonymous in the Revenue Act of 1932 or in common usage. Where, as in this case, the disputed amount was essentially a substitute for rental payments which section 22(a) expressly characterizes as gross income, it must be regarded as ordinary income, and it is immaterial that for some purposes the contract creating the right to such payments may be treated as "property" or "capital."

For the same reasons, that amount was not a return of capital because petitioner acquired the lease as an incident of the realty devised to him by his father. Theoretically, it might have been possible in such a case to value realty and lease separately and to label each a capital asset. (Compare *Maass* v. *Higgins*, No. 274, decided March 3, 1941 [Ct. D. 1494, page 434, this Bulletin]; *Appeal of Farmer*, 1 B. T. A., 711.) But that would not have converted into capital the amount petitioner received from the Trust company since section 22(b)3[2] of the 1932 Act (47 Stat., 169, 178) would have required him to include in gross income the rent derived from the property, and that section, like section 22(a), does not

[1] SEC. 22. (a) "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.

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

(3) The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income).

distinguish rental payments and a payment which is clearly a substitute for rental payments.

We conclude that petitioner must report as gross income the entire amount received for cancellation of the lease without regard to the claimed disparity between that amount and the difference between the present value of the unmatured rental payments and the fair rental value of the property for the unexpired period of the lease. The cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises. Undoubtedly it diminished the amount of gross income petitioner expected to realize, but to that extent he was relieved of the duty to pay income tax. Nothing in section 23(e) [8] indicates that Congress intended to allow petitioner to reduce ordinary income actually received and reported by the amount of income he failed to realize. (See *Warren Service Corporation* v. *Commissioner*, supra; *Josey* v. *Commissioner*, 104 Fed. (2d), 453; *Tiscornia* v. *Commissioner*, 95 Fed. (2d), 678; *Farrelly-Walsh, Inc.*, v. *Commissioner*, 13 B. T. A., 923; *Georcke Co.* v. *Commissioner*, 7 B. T. A., 860; *Merckens* v. *Commissioner*, 7 B. T. A., 32. Compare *United States* v. *Safety Car Heating Co.*, supra; *Voliva* v. *Commissioner*, 36 Fed. (2d), 212 [Ct. D. 162, C. B. IX-1, 301 (1930)]; *Appeal of Denholm*, 2 B. T. A., 444.) We may assume that petitioner was injured in so far as the cancellation of the lease affected the value of the realty. But that would become a deductible loss only when its extent had been fixed by a closed transaction. (Regulations No. 77, article 171, page 46; *United States* v. *White Dental Mfg. Co.*, 274 U. S., 398.)

The judgment of the circuit court of appeals is affirmed.

ARTICLE 22(a)-1: What included in gross income. 1941-15-10676 Ct. D. 1503

INCOME TAX—REVENUE ACT OF 1928—DECISION OF SUPREME COURT.

1. TESTAMENTARY TRUST—ASSIGNMENT OF TRUST INCOME BY LIFE BENEFICIARY FOR PERIOD OF A YEAR—INCOME TAXABLE TO ASSIGNOR.

Where the life beneficiary of a testamentary trust "assigned" to certain of her children specified amounts in dollars from the income of the trust for the year following the assignment, the assigned income, which was paid by the trustees to the several assignees, is taxable as such to the assignor. The life beneficiary, in point of substance, parted with no substantial interest in property other than the specified payments of income which, like other gifts of income, are taxable to the donor.

2. DECISIONS FOLLOWED.

Corliss v. *Bowers* [(1930) Ct. D. 188, C. B. IX-1, 254] (281 U. S., 376), *Lucas* v. *Earl* (1930) (281 U. S., 111), *Helvering* v. *Horst* [(1940) Ct. D. 1472, C. B. 1940-2, 206] (311 U. S., 112), *Helvering v. Eubank* [(1940) Ct. D. 1473, C. B. 1940-2, 209 (311 U. S., 122), and *Helvering* v. *Clifford* [(1940) Ct. D. 1444, C. B. 1940-1, 105] (309 U. S., 331), followed.

3. DECISION REVERSED.

Decision of the United States Circuit Court of Appeals, Seventh Circuit (1940) (113 Fed. (2d), 449), reversed.

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[8] SEC. 23. (e) Subject to the limitations provided in subsection (r) of this section, in the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise [shall be deductible from gross income]—

(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.

SUPREME COURT OF THE UNITED STATES.

Carter H. Harrison, Collector of Internal Revenue for the First District of Illinois, petitioner, v. *Sarah H. Schaffner.*

[61 S. Ct., 759.]

On writ of certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.

[March 31, 1941.]

OPINION.

Mr. Justice STONE delivered the opinion of the Court.

In December, 1929, respondent, the life beneficiary of a testamentary trust, "assigned" to certain of her children specified amounts in dollars from the income of the trust for the year following the assignment. She made a like assignment to her children and a son-in-law in November, 1930. The question for decision is whether, under the applicable 1928 Revenue Act (45 Stat., 791) the assigned income, which was paid by the trustees to the several assignees, is taxable as such to the assignor or to the assignees.

The Commissioner ruled that the income was that of the life beneficiary and assessed a deficiency against her for the calendar years 1930 and 1931, which she paid. In the present suit to recover the tax paid as illegally exacted the district court below gave judgment for the taxpayer, which the court of appeals affirmed. (113 Fed. (2d), 449.) We granted certiorari November 12, 1940, to resolve an alleged conflict in principle of the decision below with those in *Lucas v. Earl* (281 U. S., 111); *Burnet* v. *Leininger* (285 U. S., 136), and *Helvering* v. *Clifford* (309 U. S., 331 [Ct. D. 1444, C. B. 1940–1, 105]).

Since granting certiorari we have held, following the reasoning of *Lucas* v. *Earl*, supra, that one who is entitled to receive at a future date, interest or compensation for services and who makes a gift of it by an anticipatory assignment, realizes taxable income quite as much as if he had collected the income and paid it over to the object of his bounty. (*Helvering* v. *Horst*, 311 U. S., 112 [Ct. D. 1472, C. B. 1940–2, 206]; *Helvering* v. *Eubank*, 311 U. S., 122 [Ct. D. 1473, C. B. 1940–2, 209].) Decision in these cases was rested on the principle that the power to dispose of income is the equivalent of ownership of it and that the exercise of the power to procure its payment to another, whether to pay a debt or to make a gift, is within the reach of the statute taxing income "derived from any source whatever." In the light of our opinions in these cases the narrow question presented by this record is whether it makes any difference in the application of the taxing statute that the gift is accomplished by the anticipatory assignment of trust income rather than of interest, dividends, rents and the like which are payable to the donor.

Respondent, recognizing that the practical consequences of a gift by assignment, in advance, of a year's income from the trust, are, so far as the use and enjoyment of the income are concerned, no different from those of the gift by assignment of interest or wages, rests his case on technical distinctions affecting the conveyancing of equitable interests. It is said that since by the assignment of trust income the assignee acquires an equitable right to an accounting by the trustee which, for many purposes, is treated by courts of equity as a present equitable estate in the trust property, it follows that each assignee in the present case is a donee of an interest in the trust property for the term of a year and is thus the recipient of income from his own property which is taxable to him rather than to the donor. (See *Blair* v. *Commissioner*, 300 U. S., 5 [Ct. D. 1205, C. B. 1937–1, 175].)

We lay to one side the argument which the Government could have made that the assignments were no more than an attempt to charge the specified payments upon the whole income which could pass no present interest in the trust property. (See Scott on Trusts, sections 10.1, 10.6, 29, 30.) For we think that the operation of the statutes taxing income is not dependent upon such "attenuated subtleties," but rather on the import and reasonable construction of the taxing act. (*Lucas* v. *Earl*, supra, 114.)

Section 22(a) of the 1928 Revenue Act provides, "'Gross income' includes gains, profits, and income derived 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." By sections 161(a) and 162(b) the tax is laid upon the income "of any kind of property held in trust," and income of a trust for the taxable year which is to be distributed to the beneficiaries is to be taxed to them "whether distributed to them or not." In construing these and like provisions in other Revenue Acts we have uniformly held that they are not so much concerned with the refinements of title as with the actual command over the income which is taxed and the actual benefit for which the tax is paid. (See *Corliss* v. *Bowers*, 281 U. S., 376 [Ct. D. 188, C. B. IX1, 254 (1930)]; *Lucas* v. *Earl*, supra; *Helvering* v. *Horst*, supra; *Helvering* v. *Eubank*, supra; *Helvering* v. *Clifford*, supra.) It was for that reason that in each of those cases it was held that one vested with the right to receive income did not escape the tax by any kind of anticipatory arrangement, however skillfully devised, by which he procures payment of it to another, since, by the exercise of his power to command the income, he enjoys the benefit of the income on which the tax is laid.

Those decisions are controlling here. Taxation is a practical matter and those practical considerations which support the treatment of the disposition of one's income by way of gift as a realization of the income to the donor are the same whether the income be from a trust or from shares of stock or bonds which he owns. It is true, as respondent argues, that where the beneficiary of a trust had assigned a share of the income to another for life without retaining any form of control over the interest assigned, this Court construed the assignment as a transfer *in praesenti* to the donee, of a life interest in the corpus of the trust property and held in consequence that the income thereafter paid to the donee was taxable to him and not the donor. (*Blair* v. *Commissioner*, supra.) But we think it quite another matter to say that the beneficiary of a trust who makes a single gift of a sum of money payable out of the income of the trust does not realize income when the gift is effectuated by payment, or that he escapes the tax by attempting to clothe the transaction in the guise of a transfer of trust property rather than the transfer of income where that is its obvious purpose and effect. We think that the gift by a beneficiary of a trust of some part of the income derived from the trust property for the period of a day, a month or a year involves no such substantial disposition of the trust property as to camouflage the reality that he is enjoying the benefit of the income from the trust of which he continues to be the beneficiary, quite as much as he enjoys the benefits of interest or wages which he gives away as in the Horst and Eubank cases. Even though the gift of income be in form accomplished by the temporary disposition of the donor's property which produces the income, the donor retaining every other substantial interest in it, we have not allowed the form to obscure the reality. Income which the donor gives away through the medium of a short term trust created for the benefit of the donee is nevertheless income taxable to the donor. (*Helvering* v. *Clifford*, supra; *Hormel* v. *Helvering*, No. 257, decided March 17, 1941 [Ct. D. 1498, page 315, this Bulletin].) We perceive no difference, so far as the construction and application of the Revenue Act is concerned, between a gift of income in a specified amount by the creation of a trust for a year (see *Hormel* v. *Helvering*, supra) and the assignment by the beneficiary of a trust already created of a like amount from its income for a year.

Nor are we troubled by the logical difficulties of drawing the line between a gift of an equitable interest in property for life effected by a gift for life of a share of the income of the trust and the gift of the income or a part of it for the period of a year as in this case. "Drawing the line" is a recurrent difficulty in those fields of the law where differences in degree produce ultimate differences in kind. (See *Irwin* v. *Gavit*, 268 U. S., 161, 168 [T. D. 3710, C. B. IV-1, 123 (1925)].) It is enough that we find in the present case that the taxpayer, in point of substance, has parted with no substantial interest in property other than the specified payments of income which, like other gifts of income, are taxable to the donor. Unless in the meantime the difficulty be resolved by statute or Treasury regulation, we leave it to future judicial decisions to determine precisely where the line shall be drawn between gifts of income-producing property and gifts of income from property of which the donor remains the owner, for all substantial and practical purposes. (Cf. *Helvering* v. *Clifford*, supra.)

Reversed.

ARTICLE 22(a)-1: What included in gross income. 1941-19-10708 Ct. D. 1510

INCOME TAX—REVENUE ACT OF 1934—DECISION OF SUPREME COURT.

1. INCOME—COMPENSATION RECEIVED FOR LOSS OF BUILDINGS, MACHINERY, AND EQUIPMENT—SALE OR EXCHANGE OF CAPITAL ASSET.

The amount received in 1935 from an insurance company as compensation for the loss of buildings, machinery, and equipment which had been fully depreciated for income tax purposes prior to 1935, and no part of which was used to acquire other similar property, or to acquire control of a corporation owning such property, or to establish a fund to replace the property destroyed, was not derived from the "sale or exchange" of a capital asset. Such amount constituted ordinary income and may not be offset against capital losses sustained in that year, under section 117(d) of the Revenue Act of 1934.

2. DECISION REVERSED.

Decision of the United States Circuit Court of Appeals, Third Circuit (1940) (114 Fed. (2d), 783), reversing memorandum opinion of the United States Board of Tax Appeals (1940), reversed.

SUPREME COURT OF THE UNITED STATES.

Guy T. Helvering, petitioner, v. *William Flaccus Oak Leather Co., respondent.*
[61 S. Ct., 878.]

On writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit.

[April 28, 1941.]

OPINION.

Mr. Justice MURPHY delivered the opinion of the Court.

In September, 1935, respondent's plant was destroyed by fire. Later that year it received $73,132.50 from an insurance company as compensation for the loss of buildings, machinery, and equipment. The buildings, machinery, and equipment had been fully depreciated for income tax purposes prior to 1935, and no part of the insurance proceeds was used to acquire other property similar or related in service or use to the property destroyed, or to acquire control of a corporation owning such property, or to establish a fund to replace the property destroyed.

In its return for 1935, respondent reported the insurance proceeds as capital gain and added to that amount a gain, not in issue here, of $862.50 from sales of securities. During that same year, respondent had capital losses, also not in dispute, of $76,767.62 which it used to offset completely the total reported capital gains of $73,995. This left an excess of capital losses over capital gains of $2,772.62, and respondent deducted $2,000 of that amount from ordinary income.

The Commissioner held that the insurance proceeds were ordinary income rather than capital gain. Accordingly, he decreased respondent's capital gain and increased its ordinary income by $73,132.50, and allowed respondent capital losses of only $2,862.50, an amount equal to the gain from security sales plus $2,000. The Board of Tax Appeals affirmed in a memorandum opinion on the authority of *Estate of Herder* (36 B. T. A., 934). The circuit court of appeals reversed. (114 Fed. (2d), 783.) We granted certiorari on February 10, 1941, because the decision below was in conflict with *Herder* v. *Helvering* (106 Fed. (2d), 153).

It is conceded that respondent's losses resulted from sales or exchanges of capital assets. It is also conceded that the entire amount received from the insurance company must be included in respondent's income since the property had been fully depreciated for income tax purposes prior to 1935. Respondent contends, however, that that amount may be reported as capital gain, in order that capital losses may absorb it, rather than as an item of ordinary gross income.

Section 117(d) of the Revenue Act of 1934 (48 Stat., 680) provides in part:

"Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges." Thus, the single question is whether the amount respondent received from the insurance company derived from the "sale or exchange" of a capital asset.

Generally speaking, the language in the Revenue Act, just as in any statute, is to be given its ordinary meaning, and the words "sale" and "exchange" are not to be read any differently. (Compare *Helvering* v. *Hammel*, 311 U. S., 504; *Fairbanks* v. *United States*, 306 U. S., 436 [Ct. D. 1391, C. B. 1930-1, 260]; *Burnet* v. *Harmel*, 287 U. S., 103 [Ct. D. 611, C. B. XI-2, 210 (1932)].) Neither term is appropriate to characterize the demolition of property and subsequent compensation for its loss by an insurance company. Plainly that pair of events was not a sale. Nor can they be regarded as an exchange, for "exchange," as used in section 117(d), implies reciprocal transfers of capital assets, not a single transfer to compensate for the destruction of the transferee's asset.

The fact that section 112(f) characterizes destruction of property and indemnification for its loss as an involuntary conversion does not establish that the two events constituted a sale or exchange. That section provides: "If property (as a result of its destruction in whole or in part, theft, seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended."

We can find nothing in this language or in other sections of the Act which indicates, either expressly or by implication, that Congress intended to classify as "sales or exchanges" the involuntary conversions enumerated in section 112(f). It is true that section 111(c) says that "in the case of a sale or exchange, the extent to which the gain or loss * * * shall be recognized * * * shall be determined under the provisions of section 112." It is also true that section 112(f) follows section 112(a) which provides that "upon the sale or exchange of property the entire amount of the gain or loss * * * shall be recognized except as hereinafter provided in this section."

The inference, drawn from the juxtaposition and cross referencing of these three sections, that the involuntary conversion of respondent's property is thus implicitly characterized as a sale or exchange ignores the fact that in the same Act Congress has chosen a particular method for classifying as sales or exchanges transactions which would not ordinarily be described by one of those terms. Thus section 115(c) provides: "Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock."

Section 117(e) provides: "For the purposes of this title gains or losses from short sales of property shall be considered as gains or losses from sales or exchanges of capital assets; and gains or losses attributable to the failure to exercise privileges or options to buy or sell property shall be considered as gains or losses from sales or exchanges of capital assets held for one year or less." (See H. Rept. No. 704, Seventy-third Congress, second session, page 31; H. Rept. No. 1385, Seventy-third Congress, second session, page 23.) Section 117(f) provides: "For the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes or certificates or other evidences of indebtedness issued by any corporation * * * with interest coupons or in registered form, shall be considered as amounts received in exchange therefor." (See *McClain* v. *Commissioner*, 311 U. S., 527; *Fairbanks* v. *United States*, supra; H. Rept. No. 704, Seventy-third Congress, second session, page 31.)

These sections demonstrate that Congress has expressly specified the ambiguous transactions which are to be regarded as sales or exchanges for income tax purposes. They are convincing evidence that the involuntary conversion of respondent's property, which bears far less resemblance to a sale or exchange than the transactions embraced in sections 115(c), 117(e), and 117(f) is not to be placed in one or the other of those categories by implication. The prompt with-

drawal of article 113(a)(9)–1 of Treasury Regulations No. 86 (see T. D. 4698, C. B. XV–2, 159 [1936]) indicates that the administrators charged with the enforcement of section 112(f) reached a similar conclusion. (Compare *Burnet* v. *Chicago Portrait Co.*, 285 U. S., 1, 16 [Ct. D. 463, C. B. XI–1, 286 (1932)].)

The judgment of the circuit court of appeals is reversed.

ARTICLE 22(a)–1: What included in gross income.
(Also Section 22(b), Article 22(b)(4)–1.)

1941–21–10721
Ct. D. 1512

INCOME TAX—REVENUE ACT OF 1934—DECISION OF COURT.

2. GROSS INCOME—EXCLUSIONS—TAX-FREE INTEREST—STREET IMPROVEMENT BONDS ISSUED BY MUNICIPALITY.

The difference between the amount of a single premium payment for an endowment insurance contract and the sum of the amounts received by the insured prior to and upon maturity of the contract constitutes ordinary income and not capital gain. Section 117(f) of the Revenue Act of 1934, relating to retirement of bonds, is not applicable, in the absence of express mention therein of life insurance or endowment contracts and in the absence of showing of a legislative history indicative of the intent that they come within its scope.

2. GROSS INCOME—EXCLUSIONS—TAX-FREE INTEREST—STREET IMPROVEMENT BONDS ISSUED BY MUNICIPALITY.

Interest received by the taxpayer during the year 1935 on street improvement bonds issued by California municipalities under municipal street improvement acts of the legislature of California is exempt from Federal income tax. *Bryant* v. *Commissioner* [Ct. D. 1513, page 330, this Bulletin] (1940) (111 Fed. (2d), 9) followed.

3. DECISION REVERSED.

Memorandum opinion of the United States Board of Tax Appeals (1938) reversed.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

M. N. Avery, petitioner, v. *Commissioner of Internal Revenue, respondent.*
[111 Fed. (2d), 19.]

Upon petition to review a decision of the United States Board of Tax Appeals.

Before DENMAN, MATHEWS, and STEPHENS, Circuit Judges.

[April 12, 1940.]

OPINION.

DENMAN, Circuit Judge: Petitioner seeks review of a decision of the Board of Tax Appeals redetermining a deficiency in income tax for the year 1935 in the amount of $1,375.68.

The Board held (1) that the difference between the single premium payment and the sum of the amounts received by the petitioner prior to and upon maturity of an insurance policy was not capital gain but ordinary income, and (2) that interest received upon certain street improvement bonds was not exempt but taxable.

The insurance policy, taken out in 1925 upon payment of a single premium of $23,069.75, carried both endowment and death provisions, the insurer agreeing to pay $25,000 on April 27, 1935, to petitioner (described as "the insured")

if then living, or to certain named persons or the survivor, or to pay $25,000 "upon receipt of due proof of the death of the insured before the maturity of the endowment." [1]

It is stipulated that between the date of issuance and April 27, 1935, the insured "paid to petitioner as 'dividends' on account of said policy of insurance * * *" the total sum of $5,634, this total being made up of payments occurring at least once in each of the years subsequent to 1925 and including 1935, and that prior to the year 1935 the petitioner reported no part of this sum in his Federal income tax return.

The amount received on maturity, $25,000, plus the intervening payments of $5,634, made a total of $30,634. The difference between this total and the single premium payment of $23,069.75 was $7,564.25. This difference the petitioner treated in his 1935 income tax return as capital gain taxable under section 117 of the Revenue Act of 1934, and reported 30 per cent thereof, or $2,269.27, as the amount to be "taken into account in computing net income." [2] The Commissioner determined that none of the $7,564.25 was capital gain but that all was ordinary income. The Board agreed with the Commissioner.

Section 117(a) of the Revenue Act of 1934 provides that if a capital asset has been held for more than 10 years only 30 per cent of the gain "recognized upon the *sale* or *exchange*" thereof "shall be taken into account in computing net income." (48 Stats., 680, 714.) [Italics supplied.]

The $25,000 payment was not received upon a "sale or exchange" of the endowment contract unless section 117(f) of the Revenue Act of 1934 is applicable. (*Fairbanks* v. *United States*, 306 U. S., 436, 437; *Bodine* v. *Commissioner* (C. C. A. 3), 103 Fed. (2d), 982, 987.)

Petitioner contends that section 117(f) is applicable and that, consequently, under section 117(a) only 30 per cent of the $7,564.25 is to be "taken into account in computing net income."

Section 117(f) provides that "* * * amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation * * *, with interest coupons or in registered form, shall be considered as amounts received in exchange therefor."

The report of the Ways and Means Committee (Seventy-third Congress, second session, H. Rept. 704 [C. B. 1939-1 (Part 2), 554]) states (page 31) with reference to the provision enacted as section 117(f): "Subsection (f) provides that amounts received upon the retirement of corporate bonds and *similar* evidences of indebtedness shall be considered as amounts received in exchange therefor." [Italics supplied.]

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[1]

New York Life Insurance Company
Agrees to Pay

Endowment to insured
to Moses N. Avery, the insured
Face amount
(the face of this policy) twenty-five thousand dollars on the twenty-seventh day of April, nineteen hundred and thirty-five, if the insured is then living; or to Florence L. and Lewis G. Avery, share and share alike or to the survivor

* * * * * * *

Insurance payable at death
(the face of this policy) twenty-five thousand dollars upon receipt of due proof of the death of the insured before the maturity of the endowment.
General benefits and provisions
This policy contains the following benefits and provisions:
Participation in surplus—Dividends, section 1.

* * * * * * *

Premium
This contract is made in consideration of the payment in advance of the single premium of twenty-three thousand sixty-nine 75/100 dollars, the receipt of which is hereby acknowledged.

* * * * * * *

Section 1—Participation in surplus—Dividends.
The proportion of divisible surplus accruing upon this policy shall be ascertained annually. On each anniversary such surplus as shall have been apportioned by the company to this policy shall at the option of the insured be either
(*a*) Paid in cash; or
(*b*) Applied to purchase a participating paid-up addition to the sum insured; or
(*c*) Left to accumulate at such rate of interest as the company may declare on funds so held, but at a rate never less than 3 per cent compounded and credited annually, and withdrawable in cash on any anniversary or payable at the maturity of the policy to the person entitled to its proceeds.

* * * * * * *

[2] Section 117(a) of the Revenue Act of 1934 (48 Stats., 680, 714).

The gross income provisions of section 22 of the Revenue Act of 1932 included specific and separate provisions for the treatment of amounts received under life insurance, endowment and annuity contracts and prescribed a specific formula for the computation of the portion thereof to be included in gross income.[3] Specific and separate treatment was continued in the gross income provisions of section 22 of the Revenue Act of 1934,[4] in which Act there appeared for the first time the provisions of section 117(f). It is apparent that at least for purposes of the gross income provisions of section 22, Congress did not regard endowment contracts as "similar" to corporate bonds, but as so dissimilar as to warrant independent treatment.

Petitioner's contention would require us to hold that the formula provided in the first sentence of section 22(b)2 either is not applicable or is superfluous in instances of payment at maturity of endowment contracts. The superfluous or useless character is illustrated by the fact that the act of computing gross income under section 22(b)2 would be without significance because the gain of which the percentage is taken under section 117(a) is computed by a different formula. The difference in formula is illustrated by the fact that under the first sentence of section 22(b)2 the minuend is the total of the amounts received in the tax year and prior years or, here, $30,634, whereas in computing capital gain the minuend could not exceed $25,000 because under section 117(f) it is provided that "amounts received * * * *upon the retirement* of * * * shall be considered as amounts received in exchange therefor," and the most that could be considered as "received * * * *upon the retirement* * * *" would be the $25,000 payment. [Italics supplied.]

We are of the view that Congress did not intend that the specific formula for computation of the gain under an endowment contract to be included in gross income, provided by section 22(b)2, should be either inapplicable or superfluous in the instant case.

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[3] SEC. 22. GROSS INCOME.

* * * * * * *

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

(1) LIFE INSURANCE.—Amounts received under a life insurance contract paid by reason of the death of the insured, whether in a single sum or in installments (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);

(2) ANNUITIES, ETC.—Amounts received (other than amounts paid by reason of the death of the insured and interest payments on such amounts) under a life insurance, endowment, or annuity 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. 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;

* * * * * * *

(Revenue Act of 1932, 47 Stats., 169, 178.)

[4] SEC. 22. GROSS INCOME.

* * * * * * *

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

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

(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 title or prior income tax laws in respect of such annuity equals the aggregate premiums or consideration paid for such annuity. In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance, endowment, or annuity contract, or any interest therein, only the actual value of such consideration and the amount of the premiums and other sums subsequently paid by the transferee shall be exempt from taxation under paragraph (1) or this paragraph;

* * * * * * *

(Revenue Act of 1934, 48 Stats., 680, 686, 687.)

Petitioner contends that section 117(f) was enacted for the purpose of overcoming the principle announced in *John H. Watson, Jr.* (27 B. T. A., 463, 465), that the loss sustained from the retirement at maturity of a corporate bond was not a capital loss because no sale or exchange was involved; that at the time of the enactment of the Revenue Act of 1934 there also was in effect I. T. 2661 (C. B. XI-2, 39 (1932)) which provided:

"The gain realized from the surrender of a combined annuity and life insurance contract held for more than two years may not be treated as capital gain and taxed under section 101 of the Revenue Act of 1932, but must be treated as ordinary income."

and that the intent of Congress must have been to overcome this ruling as well as the principle announced in the Watson case. We note that in enacting section 117(f) Congress expressly used the word "bond." If it had intended that section 117(f) should apply to endowment contracts we are entitled to assume that it also would have referred in express terms to them or the class into which they had been segregated, particularly in view of the peculiar treatment Congress had accorded them in the past.

Petitioner also asserts that the purpose of section 117(f) is to place the profit accruing to an individual upon the maturity of an obligation on an equal footing with the profit accruing to an individual who actually sold an obligation to a third person before maturity. However this may be, it should be noted that section 117(f) is not all-inclusive. For example, it is limited to evidences of indebtedness of a *corporation*, and further limited to evidences of indebtedness of a corporation "*with interest coupons or in registered form.*" [Italics supplied.]

Petitioner further contends that what we are dealing with here is in fact an investment rather than a "true policy of life insurance," and cites cases in support of the investment character of an endowment contract. It is argued that this investment character brings it within section 117(f). As indicated previously, it is not every investment that is included within the limiting terms of section 117(f). Moreover, assuming the investment character of an endowment contract, any similarity to bonds which may be drawn from this character is more than outweighed by the previously mentioned dissimilar treatment accorded by Congress to endowment contracts.

In view of this dissimilarity of treatment and as we are dealing with the scope of a legislative reduction of amount to be taken into consideration in computing net income,[5] we hold that in the absence of express statutory mention of life insurance or endowment contracts in section 117(f) and in the absence of showing of a legislative history indicative of the intent that they come within its scope, section 117(f) is not applicable here.

The bond interest received was upon street improvement bonds stipulated by the parties to have been "*issued by* various California municipalities under the California Improvement Act of 1911, as amended, approved April 7, 1911, California Stats. 1911, page 730, Deering's General Laws of California, Act No. 8199." [Italics supplied.] Decision as to whether this interest was exempted by section 22(b)4 of the Revenue Act of 1934,[6] as "Interest upon * * * the obligations of a State, * * * or any political subdivision thereof * * *" is controlled by our decision in *Bryant* v. *Commissioner*, No. 9103, this day decided [Ct. D. 1513, page 330, this Bulletin], holding interest of the character here involved exempt.

In summary, we agree with the Board as to the profit from the endowment contract and hold that none of it is capital gain; we disagree with the Board as to the bond interest and hold that it is exempt.

It appears that in reaching its decision that there is a deficiency of $1,375.68 the Board treated the bond interest as taxable and that a different decision may result if, in accordance with our holding, the bond interest is treated as exempt.

The decision is reversed and the cause is remanded for further proceedings consistent with this opinion.

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[5] Cf. *White* v. *United States* (305 U. S., 281, 292)

[6] 48 Stat., 680, 687.

SECTION 22(b).—GROSS INCOME: EXCLUSIONS FROM GROSS INCOME.

ARTICLE 22(b) (2)–2: Annuities. 1941–4–10574
G. C. M. 22519

REVENUE ACT OF 1934.

Where the proceeds of a single premium endowment policy are payable at maturity in 120 equal monthly installments, the installments received constitute annuity payments and are taxable in accordance with article 22(b) (2)–2, Regulations 86, irrespective of whether the policy granted an option to the insured to take the cash surrender value at maturity, such option not having been exercised.

An opinion is requested whether the conclusion reached in G. C. M. 21666 (C. B. 1940–1, 116) would have been the same if the insurance policy involved in that ruling had granted the insured an option to take the cash surrender value of the policy at the time of maturity, but the insured did not exercise such option.

In G. C. M. 21666, supra, it was held that where the proceeds of a single premium endowment policy are payable at maturity in 120 equal monthly installments, the installments received constitute annuity payments and are taxable in accordance with article 22(b) (2)–2, Regulations 86.

It is the opinion of this office that had the policy involved in that case contained such an option which the insured did not exercise it would not have affected the conclusion reached.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

ARTICLE 22(b) (4)–1: Interest upon State obligations.

REVENUE ACT OF 1934.

Interest on street improvement bonds issued by California municipalities. (See Ct. D. 1512, page 326.)

ARTICLE 22(b) (4)–1: Interest upon State obligations. 1941–21–10722
Ct. D. 1513

INCOME TAX—REVENUE ACT OF 1934—DECISION OF COURT.

1. GROSS INCOME — EXCLUSIONS — TAX-FREE INTEREST — STREET IMPROVEMENT BONDS ISSUED BY MUNICIPALITY.

Interest received by the taxpayer during the year 1935 on street improvement bonds issued by California municipalities under municipal street improvement acts of the legislature of California is exempt from Federal income tax. Such bonds are "obligations of a State * * * or any political subdivision thereof" within the meaning of section 22(b)4 of the Revenue Act of 1934, even though payable from a special fund collected from owners of the property benefited.

2. DECISION REVERSED.

Decision of the United States Board of Tax Appeals (1938) (38 B. T. A., 618) reversed.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

Susanna Bixby Bryant, petitioner, v. *Commissioner of Internal Revenue, respondent.*

[111 Fed. (2d), 9.]

Upon petition to review a decision of the United States Board of Tax Appeals.

Before DENMAN, MATHEWS, and STEPHENS, Circuit Judges.

[April 12, 1940.]

OPINION.

DENMAN, Circuit Judge: The petitioning taxpayer seeks review of a decision of the United States Board of Tax Appeals that interest paid her during the year 1935 on street improvement bonds issued to obtain street improvements in the city of Los Angeles and in the county of Los Angeles was not "Tax-free * * * interest upon (A) the obligations of a State, * * *, or any political subdivision thereof, * * *" made exempt from the Federal income tax by section 22(b)4 of the Revenue Act of 1934 (48 Stat., 680, 687).

All the bonds here in question were issued under one or another of four municipal street improvement acts[1] of the California Legislature. It is stipulated that all four acts are alike in their pertinent features, that of 1911 under which the city of Los Angeles created certain improvements in its streets being described in this opinion.

The bonds were issued in the process of a statutory plan whereby the city acquired a public and general improvement of the streets and rights of way it owns. Initially, the city contracted with a contractor for the improvement, the obligation of which the statute required the city, in the circumstances here pertinent, to discharge by issuing its bonds and performing the bond obligations. The bonds are payable in annual installments over a period not exceeding 14 years, with semiannual interest payments. Each bond principal is for the amount of a tax assessment, imposed *in invitum* by the city's taxing power, on a separate parcel of property which has a special benefit as distinguished from the general public benefit to the city's street system as a whole. The bonds are serviced by the city's exercise of its governmental function of tax collection, its tax moneys so collected being placed in a special fund in the city treasury where it is held by the city and from which it is paid on demand of the bondholder, in effect, in the final discharge of the original contract for the city's improvement. The pertinent details of the several statutory steps, beginning with the resolution of intention of the city's legislative body to contract for the improvement of its street system and issue and service bonds in payment therefor, are hereafter considered.

The Commissioner has stipulated that the bonds here given to the contractors to accomplish the payment of the city's contracts with them are "bonds *issued by* the city of Los Angeles and the county of Los Angeles in the State of California." [Italics supplied.]

The Treasury regulation interpreting the exemption provides:

"* * * Obligations *issued by* or *on behalf* of the State or Territory or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations, are the obligations of a State or Territory or a political subdivision thereof. Special tax bills issued for special benefits to property, if such tax bills are legally collectible only from owners of the property benefited, are not the obligations of a State, Territory, or political subdivision. The term 'political subdivision,' within the meaning of the exemption, denotes any division of the State or Territory which is a municipal corporation, *or to which has been delegated the right to exercise part of the sovereign power of the State or Territory.* As thus defined, a political subdivision of a State or Territory may, for the purpose of exemption, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drain-

[1] Act of February 27, 1893 (Calif. Stats., 1893, page 33), as amended, repealed Calif. Stats., 1933, page 946; Deering's General Laws of California (1931) Act 8208. Act of April 7, 1911 (Calif. Stats., 1911, page 730), as amended; Deering's General Laws of California (1937), Act 8199. Act of June 16, 1913 (Calif. Stats., 1913, page 954), as amended; Deering's General Laws of California (1937), Act 8205. Act of June 3, 1921 (Calif. Stats., 1921, page 1658), as amended; Deering's General Laws of California (1937), Act 8289.

age, irrigation, levee, school, harbor, port improvement, *and similar districts*, and divisions of a State or Territory." [Italics supplied.]

(Article 22(b)(4)–1, Treasury Regulations 86, promulgated under the Revenue Act of 1934.)

The stipulation of the Commissioner that the bonds were "issued by" the city of Los Angeles and the county of Los Angeles bring them within the express wording of the regulation.

This regulation thus declaring these bonds, some so stipulated to have been "issued by" the city and some by the county of Los Angeles through their respective treasurers as their statutorily "constituted authorities," to be obligations of political subdivisions of California whose interest is within the exemption of the Revenue Act of 1934, is similar to the regulation first promulgated in 1919. Up to that time, it was admitted at the argument, the Treasury Department had regarded such interest as within the exemption. Since then Congress at least eight times has reenacted the exemption. On each reenactment substantially the same regulation has been promulgated. Such regulations were in force up to the filing of the briefs in this review and we have not been advised that they are not still in force.

The administrative practice at least until 1936, or for more than 22 years, appears to have been to treat as within the statutory exemption interest upon bonds which were not general obligations of the issuing political subdivision but were payable only out of a particular fund.[2] In 1936, two years after the tax year here involved, a contrary opinion was expressed in G. C. M. 16861 [C. B. XV–2, 179 (1936)].[3]

The established administrative practice of so many years, during which time the exemption was several times reenacted, carries weight as a construction of the statute which is not offset, at least as to the tax year in question, by the later expression of opinion in G. C. M. 16861 (C. B. XV–2, 179 (1936)).

In deciding this case, we need not and do not go beyond construing the Federal statute. Considering the review apart from the stipulation and the administrative construction, it appears that the statute was intended to exempt interest upon bonds of the character here involved.

The Supreme Court, in 1895, decided the case of *Pollock* v. *Farmers' Loan & Trust Co.* (157 U. S., 429, 585, 586), and gave as a basis for holding invalid a Federal tax on the interest from municipal securities the reasoning expressed by Chief Justice Marshall in *Weston* v. *City Council* (2 Pet., 449, 468), to the effect that:

"The right to tax the contract to any extent, when made, must operate upon the power to borrow, before it is exercised, and have a sensible influence on the contract. The extent of this influence depends on the will of a distinct government. To any extent, however inconsiderable, it is a burden on the operations of government * * *. The tax on Government stock is thought by this Court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States, and consequently, to be repugnant to the Constitution."

The Pollock opinion, after quoting this matter, goes on to state, page 586:

"* * * Applying this language to these *municipal* securities, it is obvious that taxation on the interest therefrom would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract and that the tax in question is a tax on the power of the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution." [Italics supplied.]

The Pollock case was decided prior to the adoption in 1913 of the sixteenth amendment, but in distinguishing between the invalidity of taxation of the bond interest and the validity of taxation of the profit from the sale of bonds, the Supreme Court quotes in the subsequent case of *Willcuts* v. *Bunn* (282 U. S., 216, 227 [Ct. D. 280, C. B. X–1, 309 (1931)]), the language of Chief Justice Marshall appearing in *Weston* v. *City Council*, supra.

It appears from congressional reports and debates that not only was the exemption enacted and reenacted because of doubt as to the effect of the sixteenth

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[2] O. D. 447 (C. B. 2, 93 (1920)); O. D. 491 (C. B. 2, 93 (1920)); I. T. 2074 (C. B. III–2, 79 (1924)); Cf G. C. M. 13469 (C. B. XIII–2, 125 (1934)); 30 Op. Atty. Gen., 252 (1914); 38 Op. Atty. Gen., 563 (1937).

[3] In I. T. 2991 (C. B. XV-2, 258 (1936)), O. D. 447 and O. D. 491 were revoked.

amendment on a source of income previously declared immune by the Pollock case,[4] but also on grounds of policy[5] apart from the constitutional question. As recently as 1938 apprehension was expressed in terms of road districts, sewer districts and the like, that a tax on the interest from State and municipal securities would burden the borrowing power of the States and their political subdivisions, whether or not that burden be regarded as one forbidden by the Constitution.[6]

Respondent contends that the bonds here involved are private rather than public in character, that they were not issued in the exercise of governmental borrowing power, but represent borrowing by private individuals. It seems to us this contention disregards realities.

Not only are the bonds public in character, they were issued in the performance of an essential governmental function. We are not concerned here with bonds to repay money borrowed to create works of a proprietary character from whose income for services rendered the bond principal and interest are paid. The borrowing here is on the pledge of governmental taxing power for improvement of streets and roads held, in California, in a governmental and not a proprietary capacity. (*McNeil* v. *City of Pasadena*, 166 Cal., 153, 155.) Cf. *Brush* v. *Commissioner* (300 U. S., 352, 371, 373 [Ct. D. 1212, C. B. 1937–1, 217]).

Our succeeding extended consideration of the statutes under which these bonds were created and of the decisions of the California courts showing that they were issued in the exercise of governmental taxing power to support governmental borrowing for the creation of governmental improvements, is made in pursuance of the principle stated by the Supreme Court that "State law creates legal interests and rights. The Federal Revenue Acts designate what interests or rights, so created, shall be taxed." (*Morgan* v. *Commissioner*, January 29, 1940, — U. S., —, —, 60 S. Ct., 424, 426.)

It is safe to say the great majority of the streets in all California cities in the last several decades have had their improvements through the issuance of bonds of the character here involved. What is true in California is true of the city streets in many States throughout the Union under legislation similar in character, of which *Commissioner* v. *Pontarelli* (C. C. A. 7) (97 Fed. (2d), 793) and *Commissioner* v. *Carey-Reed Co.* (C. C. A. 6) (101 Fed. (2d), 602) furnish examples.

When Congress enacted the exemption in 1913 there must have been outstanding hundreds of millions of dollars in such bond obligations. We believe Congress had in mind such bonds issued by American cities and that they come within the criteria it established for "the obligations of a State * * * or any political subdivision thereof, * * *" in its successive income tax Acts. (*Lyeth* v. *Hoey*, 305 U. S., 188, 194.)

At the time the bonds were issued, Article XI, section 12, of the California Constitution, considered in *American Company* v. *City of Lakeport* (220 Cal., 548, 555), provided for the creation of the municipal taxing power which supports the bonds:

"Taxes for local purposes. The legislature shall have no power to impose taxes upon *counties, cities*, towns or other public or municipal corporations, *or upon the inhabitants or property thereof*, for county, city, town or other *municipal purposes*, but may, by general laws, vest in the *corporate authorities* thereof the power to assess and collect taxes for *such* purposes." [Italics supplied.]

(Constitution of California, Treadwell (1931), Article XI, section 12.)

It is apparent from the provision of the California Constitution that the instant bonds are validly issued only if they are to repay borrowings for a "municipal purpose" as distinguished from a purpose to benefit the private property of the taxpayer. The Commissioner does not question the validity of the bonds and his stipulation admits they are issued by a municipality.

The work that may be done under the 1911 Improvement Act and paid for through the exercise of the taxing power is described in section 2 of that act which provides: "Whenever in the opinion of the city council the *public* interest or convenience may require, it is hereby authorized and empowered" to order the improvement "of the streets * * * *owned by any municipality*"

[4] 50 Congressional Record, 508, 1261–1263; H. Rept. No. 767, Sixty-fifth Congress, second session, 9; S. Rept. No. 617, Sixty-fifth Congress, third session, 6; H. Rept. No. 1037, Sixty-fifth Congress, third session, 48.

[5] S. Rept. No. 617, Sixty-fifth Congress, third session, 6; H. Rept. No. 1037, Sixty-fifth Congress, third session, 48; 83 Congressional Record, 1581–1583; 50 Congressional Record, 508, 1261–1263.

[6] 83 Congressional Record, 5182, 5183.

or of property "for the immediate possession and use of which as rights of way required for *public use*, an order has been obtained in compliance with the provisions of section 14 of Article I of the constitution of the State of California, * * *."[7] [Italics supplied.]

The public purpose of the improvement is again reflected in the provision of section 40 of the act to the effect that the city council may, at its discretion, provide by resolution that the whole or any part of the cost and expenses of any of the work mentioned in the act be paid out of the treasury of the municipality from such fund as the council may designate.

In the leading case of *Irish* v. *Hahn* (208 Cal., 339, 344),[8] we find stated the principles that a city derives its power to levy and collect a special assessment from its power of taxation and that for a valid exercise of the power of special assessment the improvement must be *public* in its nature while also conferring a special benefit upon the property assessed. First in importance in the use of the bond borrowing power is the creation of general benefit for the city as a whole.

The California Supreme Court in emphasizing that in the improvement of streets the work is for a public purpose, treats the benefits to individuals resulting therefrom as incidental. (*American Company* v. *City of Lakeport*, 220 Cal., 548, 556.) The requirement of benefit to the individual property owner is regarded as so secondary that he is not permitted to show that it will be less than the amount of the assessment. (*Larsen* v. *San Francisco*, 182 Cal., 1, 9.)

It is apparent that a district in which the streets were barred by gates to be opened only to the property owners and their permitted visitors could not be built by money borrowed on bonds created and serviced by the city. It is only where the city *as a whole* is benefited, that is, where the "municipal purpose" of Article XI, section 12, of the constitution is served, that it may bind itself for the bond's payment from its tax funds.

The first step in the exercise of a municipality's borrowing power is its resolution of intention[9] to issue to the contractor, with whom the city is to make its street improvement contract,[10] its serial bonds with annual installment of principal and semiannual interest, the interest fixed by the resolution,[11] to discharge the contract obligation when the city has obtained its improvement. The promise so to issue these bonds with their pledge to pay them by the exercise of the governmental taxing power is a necessary implication of the resolution. It is on both of these pledges to assess and collect that the contractor makes his bid for the improvement. The passage of the resolution is essential for jurisdiction for the bond issue, and its absence can not be cured and the bonds made valid by subsequent legislation. (*Chase* v. *Trout*, 146 Cal., 350, 366. Cf. *Gordon* v. *Ransome-Crummey Co.*, 37 Cal. App., 755, 757.)

It is here that the tax on the interest "operates upon the power to borrow before it is exercised." Its "sensible influence on the contract," in taking it from the wide market for the tax exempt securities, is that it will cause either the contractors bidding for the work to raise their price or the bonds to carry a higher rate of interest.

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[7] Section 14 of Article I of the California Constitution contains provisions with respect to the exercise of the power of eminent domain.

[8] From an early day in this State it has been established that a city derives its power to levy and collect a special assessment from its power of taxation. (*Emery* v. *San Francisco Gas Co.*, 28 Cal., 346.) * * * Generally speaking, the only limitations upon the exercise of the power of special assessment are that the improvement must be public in its nature, and must confer a special benefit upon the property assessed. (*Federal Construction Co.* v. *Ensign*, 59 Cal. App., 200, 216, 210 P., 536.)

On the record before us, two major questions are presented: First, was the improvement as constructed a public improvement? And, secondly, was the defendants' property specially benefited thereby? If both these questions be answered in the affirmative, it would necessarily follow that the proceedings in question were valid and the assessment is enforceable, unless the other reasons advanced by the defendants deprived the city of the power to proceed.

We think both major questions must be answered in the affirmative. It is now generally accepted that, when a municipality, lawfully so empowered, undertakes to furnish to its inhabitants who will pay therefor the utilities and facilities of urban life, it is thereby performing a municipal and public function. (See *Pasadena* v. *Chamberlain* (Cal. Supp.), 269 P., 630; *In re Orosi Public Utility Dist.*, 196 Cal., 43, 235 P., 1004. * * *.)

Numerous instances might be cited where similar improvements have been declared to be public and the constitution thereof justified under special assessment proceedings. * * *. (Citing many California cases, including those treating the act of 1911.)

[9] California Stats., 1911, page 730, sections 3, 61, as amended; Deering's General Laws of California (1937), Act 8199, sections 3, 61.

[10] Id., sections 10, 18.

[11] Id., section 61.

When the work is completed the municipality through its superintendent of streets [12] assesses against the individual pieces of property also benefited by the improvement a tax which becomes a lien thereon.[13] The bonds are for the amount of the unpaid assessment on each parcel assessed.[14]

In so creating the district, in the levying of the assessment and issuance of the bonds to be paid by the city from its tax collected fund, hereafter considered, a direct contractual relationship arises between the city and the bondholder. (*County of Los Angeles* v. *Rockhold*, 3 Cal. (2d), 192, 200.)

The assessment is *in invitum*, being valid though all the district property owners protest at the hearing before the city council which the statute provides for such protests.[15]

The contractor after completing his contract with the city first receives a tax bill or warrant and has 30 days within which to attempt to collect the tax.[16] If the property owner fails to pay it and does not state to the city treasurer before the bonds are issued that he does not desire to have his land subject to the bond [17] the city must issue it to the contractor.[18] It is apparent that if the property owner has not the money to pay the entire assessment imposed on him *in invitum* he will not prevent the issuance of the bond with its future installments of principal and interest and submit his property to an immediate foreclosure for the total amount due, unless he relies upon some legal defect in the street improvement proceeding. Such contests are the exception. In nearly every case the city's contract for its improvement is paid by collection through the tax bill or by the discharge of the bond obligation.

The municipality issues to the contractor a sufficient number of bonds to have the sum of their principal amounts equal the amount due on the contract. Many of the bonds are for very small sums. A minimum principal is $25 [19] which, on a 10-year payment, requires an annual tax collection by the treasurer of but $2.50 with a first (and largest) semiannual interest at, say, 6 per cent, or 75 cents. These bonds were transferred by the contractors and they finally reached the hands of the petitioner in this review.

When we consider the small amounts involved, it is absurd to assert that what the contractor or his "order" looks to in determining his contract price is the mere right to realize on the tax lien by a process of either governmental tax sale or judicial foreclosure. By either method the collection expenses or legal fees in a very large percentage of cases would exceed the total principal and interest. What moves the contractor to construct the municipal improvement is the anticipated performance of the city's obligation to collect the tax, place it in the fund in the city treasury, hold it there and pay it over on the demand of the bondholder.

The statute of 1911 requires the municipality to service the bond obligation of principal and interest by the exercise of the governmental power of collecting the tax from the owner of the liened property. The statute requires the city treasurer as tax collector to send his notices of the amount due and to be collected 15 days before the date of the semiannual interest payment date.[20] Upon collecting it he places it in a special fund in the city treasury for each bond issued [21] from which he must pay it on the bondholder's demand.

If the municipality fail to collect the tax and default in payment of its bond, the bondholder either may compel it to collect the tax and deposit it in the fund by the exercise of its governmental function of a tax sale,[22] or he may foreclose in a court proceeding.[23]

If there be a failure to levy the assessment, the bondholder may compel it by mandate.[24] In servicing them the city treasurer *must* act as the agent of the municipality for, as seen, the taxing power can be exercised only by the municipal corporation for the general "municipal purpose" of the improvement. He is such an agent when he collects the tax and pays it into the fund. If he collects it

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[12] Id., section 21.
[13] Id., section 23.
[14] Id., section 62.
[15] Id., section 21.
[16] Id., Sections 62, 22–25.
[17] Id., section 65.
[18] Id., section 63.
[19] Id., section 63.
[20] Id., section 62.
[21] Id., section 60.
[22] Id., section 67.
[23] Calif. Stat., 1911, page 730, section 76a, as added by Calif. Stats., 1929, page 1306; Deering's General Laws of California (1937), Act 8199, section 76a.
[24] Cf. *American Company* v. *City of Lakeport* (202 Cal., 548, 565)

and holds it otherwise than in the fund mandate will compel him to place it there.[25] If, while as such agent, he refuses to advertise the tax sale to supply the fund mandate also will lie against him.[26] All the strict construction of tax sale procedure and of tax deeds apply to the city's treasurer's acts.[27] If the treasurer has the collected tax in the fund and refuses to pay it over, mandate also will lie.[28]

All of these rights to the writ of mandate exist in the bondholder because the bonds are issued by the city in the exercise of a governmental power delegated to the municipality for the improvement, regulation and control of the highways within its boundaries.

In 1913, in construing the Vrooman act, an early statute for street improvement similar to the Street Improvement Act of 1911, the Supreme Court of California held, in *McNeil* v. *City of South Pasadena* (166 Cal., 153, 155):

"* * * The improvement, regulation, and control of the highways within a municipality call for the exercise of a delegated governmental power, a function which the municipality itself, neither by ordinance nor by contract, can surrender or impair."

In 1938 the Supreme Court of California, in *Gibson Properties Co.* v. *City of Oakland* (12 Cal. (2d), 291, 301), reaffirmed that holding in a suit seeking to make the city liable for damages claimed because of changes in the design and construction of a building made by the company in anticipation that a street opening proceeding, later abandoned, would be carried through to completion. In deciding in favor of the city the court based its decision on its holding:

"That the city in the improvement of its highways is acting in a governmental capacity is held in *McNeil* v. *City of South Pasadena* (166 Cal., 153 [135 Pac., 32, 48 L. R. A. (N. S.), 138]) and *Municipal Bond Co.* v. *City of Riverside* (138 Cal. App., 267, 274 [32 Pac. (2d), 631])."[29]

We can see no difference pertinent to the taxing claim of the Commissioner between these Los Angeles bonds and those of Chicago, also payable from a special fund, whose interest was held exempt from income taxation in *Commissioner* v. *Pontarelli* (C. C. A. 7) (97 Fed. (2d), 793), and of the Kentucky cities, also payable from special funds, and held exempt in *Commissioner* v. *Carey-Reed Co.* (C. C. A. 6) (101 Fed. (2d), 602).

The form of the bond is set forth in the statute requiring the performance of all these municipal acts in creating and servicing it. They are its implicit obligation as much a part of the bond as those it expressly assumes.[30] It is signed by the city's treasurer who promises to pay the bond from the taxes collected and paid into its fund and not otherwise. The clause reads:

"This bond is payable *exclusively from said fund*, and neither the *municipality* nor any officer thereof is to be holden for payment *otherwise* of its principal or interest." [Italics supplied.]

In our view the municipality is "holden for payment" from its tax collected moneys in its fund for the creation of its "public improvement" (*Irish* v. *Hahn*,

[25] *Fox* v. *City of Pasadena* (C. C. A. 9) (78 Fed. (2d), 948, 950).

[26] *Oakland St. Impr. Bond Co.* v. *Fitzmaurice* (47 Cal. App., 258).

[27] *Ellis* v. *Witmer* (134 Cal., 249, 66 Pac., 301); *Los Angeles Olive Growers Assn.* v. *Pozzi* (167 Cal., 454, 140 Pac., 581); *Shipman* v. *Forbes* (97 Cal., 572, 32 Pac., 599).

[28] *Meyer* v. *Porter* (65 Cal., 67, 70); See *Meyer* v. *Widber* (126 Cal., 252, 255); *Meyer* v. *City and County of San Francisco* (150 Cal., 131, 134, 135).

[29] Cf. *Municipal Bond Co.* v. *City of Riverside* (4 Cal. App. (2d), 442, 447), where the court held that the city became a trustee for the bondholder with a right to sue the official bondsmen of its city treasurer for his misappropriation of the tax collected money for the street improvement bond fund because he had received it as "an officer and agent of the municipality." In the preceding appeal in the same case the court, relying on *McNeil* v. *City of South Pasadena* (166 Cal., 153), held that the bond was issued by the city in performance of its purely governmental function of the improvement of its streets. (*Municipal Bond Co.* v. *City of Riverside*, 138 Cal. App., 267, 274.)

[30] The petitioner's bond here discussed is for a total principal of $117.49 with an annual installment of principal of $13.05, and reads in part:

117 and 49/100 No. 1

In the City of Los Angeles
County of Los Angeles, State of California

Under and by virtue of an act of the legislature of the State of California entitled "An act to provide for work in and upon streets, * * * and providing for the issuance and payment of street improvement bonds to represent certain assessments for the cost thereof, and providing a method for the payment of such bonds," approved April 7, 1911, and acts amendatory thereof, I, out of the fund for the above designated street improvement bonds, series No. Six, will pay to Griffith Company or order the sum of one hundred seventeen and 49/100 dollars ($117.49), with interest at the rate of seven (7%) per cent per annum, all as is hereinafter specified and at the office of the treasurer of the city of Los Angeles, State of California. * * *

This bond is *payable exclusively from said fund*, and neither the *municipality* nor any officer thereof is *to be holden for payment otherwise of its principal or interest.* * * *. [Italics supplied.]

supra, 344) and the bond is nonetheless an obligation of the municipality because it is not obligated to pay "otherwise" than from such a tax collected fund. From the standpoint of the taxation of the interest as upon an obligation of the municipality we can see no difference between the income of this bond interest and interest on money lent to a borrower who agrees to pay interest and principal only from the income from his apartment house which he mortgages to secure the loan.

The Commissioner's contention, in effect, is that the bond is entirely an obligation of the owner of the land upon which the tax assessment is laid *in invitum*.

His argument is based on an interpretation of the provision of the bond that since the municipality is not to be holden for payment of principal or interest "otherwise" than from its tax moneys in the fund, it is not holden to pay them to the bondholder at all. We see no merit in this contention. It ignores the fact that no contractor would make the same bid for the construction of the public improvement, if all he were to receive is the right to foreclose or have a tax sale of individual pieces of property, securing each of a bundle of bonds paying him small amounts. As was held by the Supreme Court in *Weiss* v. *Stearn* (265 U. S., 242, 254 [T. D. 3609, C. B. XII-2, 51 (1924)]), "* * * when applying the provisions of the sixteenth amendment and income laws enacted thereunder we must regard matters of substance and not mere form."

The Commissioner thus ignores the fact that the *municipality* by issuing the bond with its accompanying statutory obligations, in effect, promises, first, to exercise its governmental power of tax collection for the fund and, second, to pay the bondholder from the fund which makes possible the particular contract for the municipality's public improvement and that under *Irish* v. *Hahn*, supra, and Article XI, section 12 of the constitution of California, no such taxing power exists in the municipality unless for a "public" benefit for the city as a whole as well as a "private" benefit to landholders in the improvement of the city's streets.

The Commissioner's briefs do not mention *Irish* v. *Hahn* and rely on dicta in earlier California decisions in suits discussing the power to make "holden" the city or the State "otherwise" than on the promise to pay from the bond fund. These are *Meyer* v. *City and County of San Francisco* (150 Cal., 131, 134), *Union Trust Co.* v. *State of California* (154 Cal., 716, 725), and *Brookes* v. *City of Oakland* (160 Cal., 423).

These cases hold no more than that if the municipality has not collected the tax for the fund the city or State is not liable to pay the bonds from its *general* fund, or that special assessment liabilities are not included in a tax limitation on general obligations.

The Commissioner's cases do not and could not hold that the municipality, in obtaining its general improvements by its bond promises to collect the tax and pay the bondholder from the bond fund, is any the less engaged in borrowing than is one who obtains a loan with a promise to repay it from the income of a specific parcel of the borrower's property which is mortgaged for the debt.

To the suggestion that special assessment taxes, each imposed on *a part* as distinguished from all taxable real property in the municipality, do not diminish its borrowing power, the answer is that such taxes always have and that the depression period has given a devastating demonstration of that fact.

The origin of any municipality's borrowing power is in its power to exercise the governmental function of taxation of property in its area. The cumulation of tax liens of all kinds on the real estate in municipalities led to the so-called "tax strikes." Delinquent tax sales to the State and its subdivisions withdrew large areas from municipal taxation. From such strikes and such loss of taxable property ensued the municipal bankruptcies of the last decade.

In California a municipality may have its taxable property subject at one time to bond payments by taxation of a street district, a sewer district, a lighting district, a reclamation district, a drainage district, an irrigation district, in addition to State, county and general taxation.

Each tax invasion on the municipality's taxable property causes a lessening of borrowing power, until, as stated, many municipalities can not borrow to keep themselves out of bankruptcy. The Supreme Court in *Bekins* v. *United States* (304 U. S., 27, 48), recognizes the condition in California as stated by its legislature:

"There exist throughout the State of California economic conditions which make it impossible for property owners to pay their taxes and *special assessments* levied upon real or taxable property. The burden of such taxes and

special assessments is so onerous in amount that great delinquencies have occurred in the collection thereof and seriously affect the ability of taxing districts to obtain the revenue necessary to conduct governmental functions and to pay obligations represented by bonds. It is essential that financial relief, as set forth in this act, be immediately afforded to such taxing districts in order to avoid serious impairment of their taxing systems, with consequent crippling of the local governmental functions of the State. This act will aid in accomplishing this necessary result and should therefore go into effect immediately." [Italics supplied.]

The Supreme Court then states "similar conditions existed in other parts of the county." (See also *County of San Diego* v. *Hammond*, 5 Cal. (2d), 709, 712.)

The Commissioner also cites from a tort case arising under the Idaho laws. There the holder of bonds of an assessment district sought to hold the city of Nampa liable from its general funds because its officers had issued a certificate stating that no litigation was pending affecting their validity when, in fact, such litigation existed and ultimately caused them to be declared invalid.

On appeal of this court[31] it held that under the Idaho law the city officers "were exercising a special power vested in them with reference to local improvements, in which the city as a whole is not concerned." The Idaho law in this regard is of no application to these California bonds which can not be issued if the improvement is not general and are valid only if there be a benefit to the city as a whole. (*Irish* v. *Hahn*, supra.)

On certiorari[32] the Supreme Court held that under the Idaho statutes the city officials owed no duty to the bondholder with respect to the certificate and that the city was not liable. In the opinion, page 541, are dicta that the city's "faith or credit is not pledged and that the value of the bond depends on the validity and worth of the assessments." We take this to refer to the fact that the faith and credit of the *general* funds of the city are not pledged to pay the bonds. If it means that in Idaho there is no obligation of the municipality, first, to exercise its taxing power to collect the tax for the fund and, second, to pay it from the fund so collected to the bondholder, this is not the law of California where, as seen, the bonds are a valid pledge of the exercise of the taxing power only when the improvement created is for the city as a whole and not solely for the assessment district.

The Commissioner cites California cases holding the taxes assessed and liened on the land for the city's improvement, although imposed *in invitum*, can not be increased by subsequent legislation, because it would violate an implied contractual obligation of the liened landowner.[33] These cases recognize that the bond is supported by the municipality's governmental power of taxation, the exercise of which power we have seen is a part of the bond obligation to the bondholder.

In the most recent case cited by the Commissioner as recognizing the implied contractual character of the property owner's obligation so preventing an increased liability by later statutes, the contract between the bondholder and the municipality as an "agency" of the State is shown to be that controlling the exercise of the taxing power in the formation of the district, the levy of the assessment and the issue of the bond promising to pay from the tax collected fund:

"When a district is formed, assessments are levied, and bonds are issued, there is, of course, a *contractual relationship between the State or its agency on the one hand and the bondholder on the other.* It is *also* the settled doctrine in California that by such proceedings, a contractual relationship arises as far as the property owner is concerned." [Italics supplied.]

(*County of Los Angeles* v. *Rockhold*, 3 Cal. (2d), 192, 200.)

Here the agencies by which the "bonds are issued" are stipulated to be the county and the city of Los Angeles.

The Commissioner also claims these municipal bonds are mere tax bills or warrants within Treasury Regulations 86, article 22(b)(4)–1, which provides, "if

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[31] *Moore* v. *City of Nampa* (C. C. A. 9) (18 Fed. (2d), 860, 862).

[32] *Moore* v. *City of Nampa* (276 U. S., 536).

[33] *County of Los Angeles* v. *Rockhold* (3 Cal. (2d), 192, 44 Pac. (2d), 340, 100 A. L. R., 149); *County of San Diego* v. *Childs* (217 Cal., 109, 17 Pac. (2d), 734); *Jeffreys* v. *Point Richmond Canal & Land Co* (202 Cal., 290, 260 Pac., 548); *Palo Verde Irr. Dist.* v. *Seeley* (198 Cal., 477, 245 Pac., 1092); *La Mesa, etc., Irr. Dist.* v. *Halley* (197 Cal., 50, 239 Pac., 719); *Peery* v. *City of Los Angeles* (187 Cal., 753, 203 Pac., 992, 19 A. L. R., 1044); *Chapman* v. *Jocelyn* (182 Cal., 294, 187 Pac., 962).

such tax bills are legally collectible *only* from owners of the property benefited, [they] are not the obligations of a State, Territory, or political subdivision." Obviously the bond payable from the tax raised fund does not come within this definition of the tax bill. As we have seen, the act of 1911 itself creates a tax bill called a "warrant" which precedes the issue of the bond. It is of an entirely different character. It is issued to the contractor by the superintendent of streets and countersigned by the mayor after the city's improvement is completed.[34] It is a mere power of attorney in the contractor or his agent to demand and receive the assessed tax from the individual property owners. The bond with its promise *by the city* to collect the taxes, hold them in the fund, and pay them on the bondholder's demand is issued after the failure of the contractor as a private person to collect the amount due through the tax bill. Whether, despite the Treasury regulation, such tax bills are such income tax exempt obligations is a matter with which we are not here concerned.

The Board of Tax Appeals decision erred in sustaining the Commissioner's inclusion in petitioner's taxable income of the interest of the municipality's bonds issued to discharge the obligation of the city's contract for its street improvement and is reversed.

Reversed.

SECTION 22(c).—GROSS INCOME: INVENTORIES.

ARTICLE 22(c)–8: Inventories of retail merchants.

REVENUE ACT OF 1934.

Regulations 86, amended. (See T. D. 5048, page 200.)

SECTION 23(a).—DEDUCTIONS FROM GROSS INCOME: EXPENSES.

ARTICLE 23(a)–1: Business expenses. 1941–7–10598
Ct. D. 1486

INCOME TAX—REVENUE ACT OF 1932—DECISION OF SUPREME COURT.

1. DEDUCTION—ORDINARY AND NECESSARY EXPENSE—TRADE OR BUSINESS—APPORTIONMENT OF EXPENSE BETWEEN REAL ESTATE AND SECURITY INVESTMENTS.

An individual with extensive investments in real estate and income-producing securities, who did not participate directly or indirectly in the management of the corporations in which he held stock or bonds, and whose financial affairs had been conducted for many years by office employees pursuant to his personal instructions, was not carrying on a trade or business within the meaning of section 23(a) of the Revenue Act of 1932, so far as the security investments were concerned, and therefore was not entitled to a deduction for expenses attributable to the securities. Although the real estate and security matters were handled by the same office, the expenses were capable of apportionment between real estate and security investments.

2. DECISION AFFIRMED.

Decision of the United States Circuit Court of Appeals, Second Circuit (1940) (111 Fed. (2d), 795), affirming decision of the United States Board of Tax Appeals (1939) (39 B. T. A., 1005), affirmed.

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[34] Calif. Stats., 1911, page 730, sections 22, 23, as amended; Deering's General Laws of California (1937), Act 8199, sections 22, 23.

SUPREME COURT OF THE UNITED STATES.

Eugene Higgins, petitioner, v. *Commissioner of Internal Revenue.*
[312 U. S., 212.]

On writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[February 3, 1941.]

OPINION.

Mr. Justice REED delivered the opinion of the Court.

Petitioner, the taxpayer, with extensive investments in real estate, bonds and stocks, devoted a considerable portion of his time to the oversight of his interests and hired others to assist him in offices rented for that purpose. For the tax years in question, 1932 and 1933, he claimed the salaries and expenses incident to looking after his properties were deductible under section 23(a) of the Revenue Act of 1932.[1] The Commissioner refused the deductions. The applicable phrases are: "In computing net income there shall be allowed as deductions: (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *." There is no dispute over whether the claimed deductions are ordinary and necessary expenses. As the Commissioner also conceded before the Board of Tax Appeals that the real estate activities of the petitioner in renting buildings[2] constituted a business, the Board allowed such portions of the claimed deductions as were fairly allocable to the handling of the real estate. The same offices and staffs handled both real estate and security matters. After this adjustment there remained for the year 1932 over 20 and for the year 1933 over 16 thousand dollars expended for managing the stocks and bonds.

Petitioner's financial affairs were conducted through his New York office pursuant to his personal detailed instructions. His residence was in Paris, France, where he had a second office. By cable, telephone and mail, petitioner kept a watchful eye over his securities. While he sought permanent investments, changes, redemptions, maturities and accumulations caused limited shiftings in his portfolio. These were made under his own orders. The offices kept records, received securities, interest and dividend checks, made deposits, forwarded weekly and annual reports and undertook generally the care of the investments as instructed by the owner. Purchases were made by a financial institution. Petitioner did not participate directly or indirectly in the management of the corporations in which he held stock or bonds. The method of handling his affairs under examination had been employed by petitioner for more than 30 years. No objection to the deductions had previously been made by the Government.

The Board of Tax Appeals[3] held that these activities did not constitute carrying on a business and that the expenses were capable of apportionment between the real estate and the investments. The circuit court of appeals affirmed,[4] and we granted certiorari because of conflict.[5]

Petitioner urges that the "elements of continuity, constant repetition, regularity and extent" differentiate his activities from the occasional like actions of the small investor. His activity is and the occasional action is not "carrying on business." On the other hand, the respondent urges that "mere personal investment activities never constitute carrying on a trade or business, no matter how much of one's time or of one's employees' time they may occupy."

Since the first income tax Act, the provisions authorizing business deductions have varied only slightly. The Revenue Act of 1913[6] allowed as a deduction "the necessary expenses actually paid in carrying on any business." By 1918 the present form was fixed and has so continued.[7] No regulation has ever been promulgated which interprets the meaning of "carrying on a business," nor any

[1] 47 Stat., 169, ch. 209.
[2] Cf. *Pinchot* v. *Commissioner* (113 Fed. (2d), 718).
[3] 39 B. T. A., 1005.
[4] 111 Fed. (2d), 795.
[5] *Kales* v. *Commissioner* (101 Fed. (2d), 35); *du Pont* v. *Deputy* (103 Fed. (2d), 257).
[6] 38 Stat., 167, Section II B.
[7] 40 Stat., 1066, section 214(a)1.

rulings approved by the Secretary of the Treasury, i. e., Treasury decisions.[8] Certain rulings of less dignity, favorable to petitioner,[9] appeared in individual cases but they are not determinative.[10] Even acquiescence [11] in some Board rulings after defeat does not amount to settled administrative practice.[12] Unless the administrative practice is long continued and substantially uniform in the Bureau and without challenge by the Government in the Board and courts, it should not be assumed, from rulings of this class, that Congressional reenactment of the language which they construed was an adoption of their interpretation.

While the Commissioner has combated views similar to petitioner's in the courts, sometimes successfully [13] and sometimes unsuccessfully,[14] the petitioner urges that the Bureau accepted for years the doctrine that the management of one's own securities might be a business where there was sufficient extent, continuity, variety and regularity. We fail to find such a fixed administrative construction in the examples cited. It is true that the decisions are frequently put on the ground that the taxpayer's activities were sporadic but it does not follow that had those activities been continuous the Commissioner would not have used the argument advanced here, i. e., that no amount of personal investment management would turn those activities into a business. Evidently such was the Government's contention in the Kales case,[15] where the things the taxpayer did met petitioner's tests, and in *Foss* v. *Commissioner* [16] and *Washburn* v. *Commissioner* [17] where the opinions turned on the extent of the taxpayer's participation in the management of the corporations in which investments were held.[18]

Petitioner relies strongly on the definition of business in *Flint* v. *Stone Tracy Co.*: [19] "'Business' is a very comprehensive term and embraces everything about which a person can be employed." This definition was given in considering whether certain corporations came under the corporation tax law which levies a tax on corporations engaged in business. The immediate issue was whether corporations engaged principally in the "holding and management of real estate" [20] were subject to the Act. A definition given for such an issue is not controlling in this dissimilar inquiry.[21]

To determine whether the activities of a taxpayer are "carrying on a business" requires an examination of the facts in each case. As the circuit court of appeals observed, all expenses of every business transaction are not deductible. Only those are deductible which relate to carrying on a business. The Bureau of Internal Revenue has this duty of determining what is carrying on a business, subject to reexamination of the facts by the Board of Tax Appeals [22] and ultimately to review on the law by the courts on which jurisdiction is conferred.[23] The Commissioner and the Board appraised the evidence here as insufficient to establish petitioner's activities as those of carrying on a business. The petitioner merely kept records and collected interest and dividends from his securities, through managerial attention for his investments. No matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board. Its conclusion is adequately supported by this record, and rests upon a conception of carrying on business similar to that expressed by this Court for an antecedent section.[24]

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[8] Cf. *Helvering* v. *New York Trust Co.* (292 U. S., 455, 467–468 [Ct. D. 840, C. B. XIII–1, 188 (1934)]).

[9] O. D. 537 (C. B. 2, 175 (1920)); O. D. 877 (C. B. 4, 123 (1921)); I. T. 2751 (C. B. XIII–1, 43 (1934)).

[10] *Biddle* v. *Commissioner* (302 U. S., 573, 582 [Ct. D. 1303, C. B. 1938–1, 309]). Cf. *Estate of Sanford* v. *Commissioner* (308 U. S., 39, 52). But see *Helvering* v. *Bliss* (293 U. S., 144, 151 [Ct. D. 884, C. B. XIII–2, 191 (1934)]), and *McFeely* v. *Commissioner* (296 U. S., 102, 108 [Ct. D. 1040, C. B. XIV–2, 209 (1935)]).

[11] *Kissel* v. *Commissioner* (15 B. T. A., 1270, acquiesced in, C. B. VIII–2, 28 (1929)); *Croker* v. *Commissioner* (27 B. T. A., 588, acquiesced in, C. B. XII–1, 4 (1933)).

[12] *Higgins* v. *Smith* (308 U. S., 473, 478–479).

[13] *Bedell* v. *Commissioner* (30 Fed. (2d), 622, 624); *Monell* v. *Helvering* (70 Fed. (2d), 631 [Ct. D. 896, C. B. XIII–2, 288 (1934)]); *Kane* v. *Commissioner* (100 Fed. (2d) 382).

[14] *Kales* v. *Commissioner* (101 Fed. (2d), 35); *du Pont* v. *Deputy* (103 Fed. (2d), 257, 259, reversed on other grounds, 308 U. S., 488 [Ct. D. 1435, C. B. 1940–1, 118]).

[15] *Kales* v. *Commissioner* (34 B. T. A., 1046, 101 Fed. (2d), 35).

[16] 75 Fed. (2d), 326.

[17] 51 Fed. (2d), 949, 953.

[18] Cf. *Roebling* v. *Commissioner* (37 B. T. A., 82); *Heilbroner* v. *Commissioner* (34 B. T. A., 1200).

[19] 220 U. S., 107, 171.

[20] Id., 169.

[21] *Cohens* v. *Virginia* (6 Wheat., 264, 399); *Puerto Rico* v. *Shell Co.* (302 U. S., 253, 269).

[22] Revenue Act of 1932 (47 Stat., 169, section 272); Internal Revenue Code, section 272.

[23] Internal Revenue Code, section 1141.

[24] *Van Wart* v. *Commissioner* (295 U. S., 112, 115 [Ct. D. 963, C. B. XIV–1, 292 (1935)]).

The petitioner makes the point that his activities in managing his estate, both realty and personalty, were a unified business. Since it was admittedly a business in so far as the realty is concerned, he urges, there is no statutory authority to sever expenses allocable to the securities. But we see no reason why expenses not attributable, as we have just held these are not, to carrying on business can not be apportioned. It is not unusual to allocate expenses paid for services partly personal and partly business.[25]

Affirmed.

ARTICLE 23(a)-1: Business expenses.

1941-19-10709
Ct. D. 1509

INCOME TAX—REVENUE ACT OF 1934—DECISION OF SUPREME COURT.

1. DEDUCTION—ATTORNEYS' FEES—ORDINARY AND NECESSARY EXPENSE—TRADE OR BUSINESS.

Upon the record presented, attorneys' fees properly incurred in the administration of an estate and paid by the executors during the taxable year 1934 are not deductible from gross income of the estate under section 23(a) of the Revenue Act of 1934 as expenses paid or incurred in carrying on a trade or business. The finding of the Court of Claims that the executors continued to conserve the decedent's estate as he had when he was himself "a financier and investor" is not sufficient to support a conclusion that the executors were carrying on business within the meaning of the statute.

2. CASE DISTINGUISHED.

Flint v. *Stone Tracy Co.* (220 U. S., 107) distinguished.

3. JUDGMENT VACATED.

Judgment of the Court of Claims (1940) (35 Fed. Supp., 81) vacated.

SUPREME COURT OF THE UNITED STATES.

The United States, petitioner, v. *Herbert Rivington Pyne, Grafton Howland Pyne, Mary Pyne Filley, and Percy R. Pyne, Jr., Executors of the Estate of Percy R. Pyne.*

[61 S. Ct. 893.]

On writ of certiorari to the Court of Claims.

[April 28, 1941.]

OPINION.

Mr. Justice BLACK delivered the opinion of the Court.

The question presented is whether upon this record the Court of Claims[1] committed error in concluding that respondents, as executors, were, in computing their Federal income tax, entitled to deduct expenses properly incurred in the administration of an estate, Congress having provided that such a deduction could be taken only by individuals, estates, or trusts engaged in "carrying on * * * business." (Revenue Act of 1934, sections 23(a), 161, 162.) (Compare *City Bank Farmers Trust Co.* v. *Helvering*, just announced [Ct. D. 1511, page 344, this Bulletin].)

In computing the 1934 net income of the estate, respondents claimed a deduction of $40,000 for fees paid to the estate's attorney during the taxable year. The Commissioner of Internal Revenue disallowed the deduction; the respondents paid under protest, and filed suit for refund in the Court of Claims. Their complaint alleged that "The payment of attorney's fees and the claim for allowance thereof as a deduction from gross income is predicated upon the contention that the tremendous size of the corpus of the estate and the proper administration thereof constituted the operation of a business and the employment of an attorney as counsel to guide the executors in the handling

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[25] 3 Paul & Mertens, Law of Federal Income Taxation, section 23.65; cf. *National Outdoor Advertising Bureau* v. *Helvering* (89 Fed. (2d), 878, 881).

[1] 35 Fed. Supp., 81.

of the affairs of the estate was just as much a necessary expense of the estate as is incurred in the operation of any commercial business engaged in the manufacturing or selling of commodities." The court made detailed findings of fact, and as its single conclusion of law stated that the respondents should recover.

We recently stated in *Higgins* v. *Commissioner* (311 U. S., — [Ct. D. 1486, page 339, this Bulletin]) that determination of what amounts to carrying on business requires examination of the facts in each case. In this case, the record before us contains the findings of the Court of Claims, a conclusion of law, and an opinion summarizing the findings of fact and indicating the reasons which prompted the court to reach its conclusion of law. The most that can be said of the findings of fact is that the court was of the opinion that the facts found showed that the activities of the executors were such as to meet certain criteria set out in the opinion as determinative of what constituted carrying on business. For what the court found as a fact was that the decedent, prior to his death "was engaged in business as a financier and investor, maintaining an office where he employed an office manager and an average of six clerks. * * * In general, the operations of the estate continued in substantially the same manner after the decedent's death as before * * *." In addition the court found that the attorney employed by the executors "was called upon to advise them with reference to matters both legal and economic that arose in the business activities of the estate, with reference to Federal estate and State inheritance taxes, and also in regard to the acquisition and disposal of the estate's securities and in regard to various matters pertaining to companies in which the estate held investments." But the executors might do all the things that the court found that they did and still not be engaged in "carrying on * * * business" within the meaning of the Revenue Act. For as we said in the Higgins case, "All expenses of every business transaction are not deductible. Only those are deductible which relate to carrying on a business." Also, we there sustained a holding that an individual who was engaged in financial and investing activities in all ways similar to those of the decedent and his executors in this case was not entitled to a deduction such as that sought by respondents. Therefore, the finding of the Court of Claims that the executors continued to conserve the decedent's estate as he had when he was himself "a financier and investor" falls far short of a finding that the executors were entitled to a deduction accorded by Congress only to those "carrying on * * * business." Failure of the Court of Claims to make a specific finding on this ultimate and determinative issue deprives that court's judgment of support. Under such circumstances we are not called upon to weigh the different facts set out in the subsidiary findings in order to determine whether or not they would support a conclusion that the executors were "carrying on * * * business" within the meaning of the statute.[2]

When we turn to the opinion of the Court of Claims,[3] it is made clear that absence of such a specific finding was the result of the court's adoption of criteria of "carrying on * * * business" inconsistent with our holding in the Higgins case. Since the judgment must be vacated because not supported by adequate findings, it is appropriate that we point out this inconsistency. Accepting as true the statement of the Court of Claims that a broad definition of "business" might be that it is "whatever engages the time, attention, and labor of men in order to conserve what they have or to avoid loss" it does not follow at all that this is synonymous with the statutory language, "carrying on * * * business." This definition of "business" stems in part from the case of *Flint* v. *Stone Tracy Co.* (200 U. S., 107, 171), upon which the Court of Claims relied. But however applicable that definition may have been to the case there under consideration, it can not be accepted as a guide in the present case. The reasons why it is not applicable to the statutory provision now under consideration were given in our opinion in the Higgins case; its nonapplicability to specific situations has also been explained in a number of other opinions of this Court.[4]

Nor can the judgment of the Court of Claims be supported by that court's statement that the executors were engaged "in the business of conserving the estate and

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[2] *United States* v. *Esnault-Pelterie* (299 U. S., 201, 206).

[3] Cf. *Chippewa Indians of Minnesota* v. *United States* (305 U. S., 479, 481); *American Propeller & Mfg. Co.* v. *United States* (300 U. S., 475, 479–480 [Ct. D. 1218, C. B. 1937–1, 267]).

[4] See, e. g., *Von Baumbach* v. *Sargent Land Co.* (242 U. S., 503, 514–515); *McCoach* v. *Minehill & Schuylkill Haven R. R.* (228 U. S., 295, 303); *Zonne* v. *Minneapolis Syndicate* (220 U. S., 187, 190).

protecting its income." Such activities are the traditional duty of executors. Executors who engage actively in trade and business are the exception and not the rule. Rather obviously, there could be clear cases where executors "carry on * * * business" by continuing to operate a store, a factory or some other well known, well marked type of business activity. But in the absence of evidence showing activities coming within the general acceptation of the concept of carrying on a trade or business, it can not be said as a matter of law that an executor comes into this category merely because he conserves the estate by marshaling and gathering the assets as a mere conduit for ultimate distribution. And determination of what constitutes "carrying on * * * business" under the Revenue Act does not depend upon the size of the estate or the number of people whose services are required in order properly to conserve it.

The judgment of the Court of Claims is vacated and the cause is remanded to that court for proceedings in accordance with the views herein expressed.

It is so ordered.

ARTICLE 23(a)–1: Business expenses.

1941–19–10710
Ct. D. 1511

INCOME TAX—REVENUE ACT OF 1928—DECISION OF SUPREME COURT.

1. DEDUCTION—TRUSTEES' COMMISSIONS—ORDINARY AND NECESSARY EXPENSE—TRADE OR BUSINESS—TRUST AND INDIVIDUAL SUBJECT TO SAME RULE IN COMPUTING NET INCOME.

Commissions paid in 1931 to testamentary trustees pursuant to surrogate court order are not deductible from trust income under section 23(a) of the Revenue Act of 1928 as expenses paid or incurred in carrying on a trade or business. *Higgins* v. *Commissioner* [Ct. D. 1486, page 339, this Bulletin] (311 U. S., —), decided February 3, 1941, is controlling, even though administrative practice, which has not received support by Treasury regulations, has permitted such deductions. The statute expressly provides that the same method and basis of computation must be applied to trust income as to individual income.

2. DECISION AFFIRMED.

Decision of the United States Circuit Court of Appeals, Second Circuit (1940) (112 Fed. (2d), 457), affirming decision of the United States Board of Tax Appeals (1939) (39 B. T. A., 29), affirmed.

SUPREME COURT OF THE UNITED STATES.

City Bank Farmers Trust Co., as Trustee of a Trust Under the Last Will and Testament of Angier B. Duke, Deceased, for the Benefit of Anthony Newton Duke, petitioner, v. *Guy T. Helvering, Commissioner of Internal Revenue.*

City Bank Farmers Trust Co., as Trustee of a Trust Under the Last Will and Testament of Angier B. Duke, Deceased, for the Benefit of Angier B. Duke, Jr., petitioner, v. *Guy T. Helvering, Commissioner of Internal Revenue.*

[61 S. Ct., 896.]

On writs of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[April 28, 1941.]

OPINION.

Mr. Justice BLACK delivered the opinion of the Court.

The ultimate question here involved is whether two testamentary trusts of which petitioner is trustee were in 1931 "carrying on * * * business" within the meaning of section 23(a) of the Revenue Act of 1928.

Pursuant to the will of Angier B. Duke, two trusts, consisting of stocks and bonds worth approximately $7,600,000, were established in 1923 for the benefit of Duke's two minor sons. Petitioner, as trustee, was charged with the duty of applying a sufficient amount of the income of each trust to the support and education of the beneficiary; the surplus income was to be accumulated until

the beneficiary's majority; and at that time all accumulated income was to be paid to the beneficiary, while the principal was to be continued in trust for the benefit of the son and his descendants. By 1931, the principal and accumulated income of the two trusts aggregated about $10,000,000. In that year the Surrogate Court of New York County allowed trustees' commissions of about $77,000, ordering that payment be made out of principal. In reporting trust income for 1931, the trustee did not claim any deduction for these commissions. Later, in proceedings before the Board of Tax Appeals, the deduction was claimed but denied. The ground of denial was that during the taxable year the trusts had not been "carrying on any trade or business," the carrying on of such an activity being a condition precedent to the allowance of the claimed deduction under the controlling Revenue Act.[1] The circuit court of appeals affirmed.[2] Differing interpretations as to the meaning and scope of "carrying on any trade or business" prompted us to grant certiorari in this case, in the case of *Pyne* v. *United States* (35 Fed. Supp., 81), and in the case of *Higgins* v. *Commissioner* (111 Fed. (2d), 795, 311 U. S., — [Ct. D. 1486, page 339, this Bulletin]).

In the Higgins case, decided on February 3, we affirmed the judgment of the same circuit court of appeals that rendered the decision below. Higgins, an individual taxpayer whose activities did not vary materially from the activities of the taxpaying trusts in the case at bar,[3] was denied the deduction which petitioner here seeks. And sections 161–162 of the Revenue Act of 1928 provide: "The taxes imposed by this title upon individuals shall apply to the income of estates or of any kind of property held in trust. * * * The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual. * * *." Since the trust is subject to the same rules as the individual, and since the findings of the Board of Tax Appeals in the Higgins case and in the case at bar are substantially the same,[4] the Higgins case is controlling here, unless, as petitioner contends, distinguishable by reason of administrative practice in relation to trusts.

But we regard the Higgins decision as controlling despite petitioner's insistence that administrative practice has long permitted deduction of trustees' commissions. In view of the express Congressional command that the same method and basis of computation must be applied to trust income as to individual income, it is doubtful whether any administrative practice, no matter how clear or long existing, would warrant our applying one concept of carrying on business in the case of an individual and another concept in the case of a trust. This is particularly true here, where the statutory interpretation petitioner urges has never received support in any regulations promulgated by the Secretary of the Treasury.[5] And not only is the result reached by the court below consistent with our decision in *Higgins* v. *Commissioner*, but, as we said in the Higgins case, the conclusion of the Board

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[1] Revenue Act of 1928, sections 23(a), 161, 162. (Cf. *George Vanderbilt Trust*, 36 B. T. A., 967.) Though petitioner urges that the Commissioner, because of concessions made before the Board of Tax Appeals, should be barred from asserting that the trusts were not carrying on business, the judgment of the Board rested on its finding that the trusts were not so engaged, and the issue is properly before us.

[2] 112 Fed. (2d), 457.

[3] The Board found in this case that the trustee's activities were limited to reviewing the stocks and bonds in trust several times a year; selling securities and reinvesting the proceeds in other stocks and bonds; collecting interest and dividends on security; keeping account books for the trusts and rendering statements to the interested parties; preparing and filing income tax returns; and distributing income to the beneficiaries. Summarizing, the Board of Tax Appeals said, "The above facts demonstrate conclusively to us that this is a case of passive investment and not of carrying on a business, for not only is the trustee limited in its investments, but it is cautioned in effect to be a safe investor rather than a participant in trade or business, and, plainly carrying out the testator's injunctions, it conducts no business, because it has, as above seen, no expenses of conducting business other than the collection of coupons and mailing bonds, amounting to a few dollars, and an even more negligible amount for transfer stamps or notary fees. * * * Extensive authority need not be compiled to demonstrate that a mere passive investor, collecting interest and clipping coupons, and making a very few reinvestments, is not engaged in trade or business."

[4] It is clear that the Board was justified in reaching the conclusion that the instant trusts were not "business trusts," but existed merely to hold and conserve property and distribute the income received. (Compare *Morrisey* v. *Commissioner*, 296 U. S., 344, 356–357 [Ct. D. 1064, C. B. XV–1, 264 (1936)]; *Von Baumbach* v. *Sargent Land Co.*, 242 U. S., 503, 515; *Zonne* v. *Minneapolis Syndicate*, 220 U. S., 187.)

[5] *Riddle* v. *Commissioner* (302 U. S., 573, 582 [Ct. D. 1303, C. B. 1938–1, 309]; *Helvering* v. *New York Trust Co.* (292 U. S. 455, 467–468 [Ct. D. 840, C. B. XIII–1, 188 (1934)]).

of Tax Appeals "is adequately supported by this record, and rests upon a conception of carrying on business similar to that expressed by this Court for an antecedent section."[6] The judgment below is accordingly affirmed.

ARTICLE 23(a)-1: Business expenses.

REVENUE ACT OF 1934 AND PRIOR REVENUE ACTS.

Expenses incurred in production of taxable income. (See I. T. 3452, page 205.)

ARTICLE 23(a)-2: Traveling expenses.

REVENUE ACT OF 1921.

I. T. 1497 (C. B. I.-2, 89 (1922)) modified. (See I. T. 3474, page 207.)

SECTION 23(c).—DEDUCTIONS FROM GROSS INCOME: TAXES GENERALLY.

ARTICLE 23(c)-1: Taxes. 1941-8-10611
Ct. D. 1490

INCOME TAX—REVENUE ACT OF 1918—DECISION OF COURT.

DEDUCTION—MASSACHUSETTS CORPORATION EXCISE TAX—ACCRUAL.

A Massachusetts corporation which kept its books and prepared its returns of net income on the accrual basis of accounting and filed its income tax returns on the calendar year basis, and which paid to the State in 1921 an excise tax for the year 1920 equal to the sum of a prescribed percentage of its 1920 net income for Federal income tax purposes and a percentage of the value of its "corporate excess" determined as of April 1, 1921 (the date of assessment under State law), is entitled to a deduction from 1920 gross income for the portion of the State tax representing the first factor in the computation, although the second factor was not ascertainable until after the date of assessment. For Federal income tax purposes, the two factors comprising the excise tax are separable, and the amount of tax attributable to net income "accrued" during 1920 within the meaning of section 234(a) of the Revenue Act of 1918.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT.

George S. Colton Elastic Web Co., plaintiff, appellant, v. *United States of America, defendant, appellee.*[a]

[116 Fed. (2d), 202.]

Appeal from the District Court of the United States for the District of Massachusetts.

[December 9, 1940.]

OPINION.

MAGRUDER, J.: This action was brought for the recovery of alleged overpayments of income and excess profits taxes for the calendar year 1920. A written agreement of the parties[1] has suspended the running of the statute of limitations.

The facts were stipulated below. The appellant is a Massachusetts corporation which kept its books of account and records and prepared its returns of

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[6] The case referred to was *Van Wart* v. *Commissioner* (295 U. S., 112, 115).

[a] See G. C. M. 22525, page 350, this Bulletin.

[1] Entered into in accordance with section 608(b)(2) of the Revenue Act of 1928 (45 Stat., 874), as amended, Internal Revenue Code, section 3774 (48 Stat., 756).

net income on the accrual basis of accounting for calendar years. In 1921 it paid the Massachusetts domestic corporation tax assessed as of April 1, 1921. At that time this tax was ascertained by adding together an amount equal to 0.5 per cent of the "corporate excess," determined as of April 1, 1921, and an amount equal to 2½ per cent of the corporation's net income as reported to the Federal Government on its last income tax return prior to April 1, 1921.[2] The amount paid under the first factor was deducted in the Federal return for 1921, and no question is raised as to the propriety of that deduction. The amount paid under the second factor was $3,336.27. The sole issue involved in the present appeal is whether or not this sum "accrued," within the meaning of section 234(a) of the Revenue Act of 1918,[3] during 1920, and thus became deductible from the appellant's gross income for that year.

In essence, our decision must turn upon the question whether, for income tax accounting purposes, the two factors comprising the Massachusetts domestic corporation tax should be regarded as a single, indivisible unit or as separate items. If the tax is regarded as a unit, then the total amount of the tax could not be ascertained until April 1, 1921, since by definition the amount of "corporate excess" could be determined only as of that date. If, however, the tax should be regarded as comprised of two separable items, then the amount due under section 2(2), fixed as a percentage of the taxpayer's net income for 1920, was mathematically determinable on December 31, 1920. The court below, disallowing the deduction, ruled that the tax must be regarded as a single, inseparable item, in view of the language of the Massachusetts Supreme Judicial Court that "This tax is a single excise * * *." (*Springdale Finishing Co.* v. *Commonwealth*, 242 Mass., 37 (1922).)[4]

We do not think this language is determinative of the issue in the case at bar. Certainly the characterization of the excise as "single," apparently directed to the question of constitutionality, is not conclusive upon us in determining how the Massachusetts tax is to be treated for Federal income tax purposes. However, as an interpretation of the Massachusetts statute involved, and as an indication of the liabilities of corporate taxpayers under that act, the Springdale decision is of course binding upon us. The case involved a corporation which sold out its business in July, 1920. During 1920 it had paid the domestic corporation tax based upon its "corporate excess" as of April 1. 1920, and its net income during the calendar year 1919. The Commonwealth of Massachusetts, contending that this payment did not free the corporation from liability for a further payment of a corporate excise tax based upon the net income earned during 1920, accelerated the due date of the tax under General Laws, chapter 63, section 76,[5] and brought suit for the tax otherwise payable

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[2] Massachusetts General Acts of 1919, chapter 355:

PART I. DOMESTIC CORPORATION TAX.

SECTION 1. When used in Part I of this act:— * * *

(2) The term "taxable year" shall mean the fiscal year of the corporation.

(3) The term "corporate excess" shall mean the fair cash value of all the shares constituting the capital stock of a corporation on the 1st day of April when the return called for by section 4 of this act is due. * * *

SEC. 2. Except as is otherwise provided in this section, every domestic business corporation shall be subject to pay annually, with respect to the carrying on or doing of business by it, an excise tax equal to the sum of the following:

(1) An amount equal to $5 per thousand upon the value of its corporate excess.

(2) An amount equal to 2½ per cent of that part of its net income as hereinafter defined which is derived from business carried on within this Commonwealth * * *.

SEC. 3. Except as provided in the last paragraph of section 2, the term "net income" shall mean the net income for the taxable year as required to be reported by the corporation in its last prior return to the Federal Government as defined in the Federal Revenue Act of 1918. * * *

SEC. 4. Every such corporation shall, within the first 10 days of April, make a return as of April 1st, sworn to by the treasurer or assistant treasurer, or in their absence or incapacity by any other principal officer, in such form as the tax commissioner may prescribe * * *.

[3] SEC. 234. (a) That in computing the net income of a corporation * * * there shall be allowed as deductions: * * *

(3) Taxes paid or accrued within the taxable year * * * (40 Stat., 1077.)

[4] The district court reached the same result, for the same reason, in *Consolidated Dry Goods Co.* v. *United States*. That case involved the same issues and, by stipulation of the parties, it will be governed on appeal by our decision in this case.

[5] The sale or transfer, otherwise than in the ordinary course of trade and in the regular and usual prosecution of the corporation's business, of any part or the whole of the assets of a domestic business corporation shall be fraudulent and void as against the Commonwealth, unless such corporation shall, at least five days before the sale or transfer, notify the [tax] commissioner of the proposed sale or transfer * * *. Whenever such a corporation shall make such a sale or transfer, the tax * * * shall become due and payable at the time when the commissioner is so notified, or, if he is not so notified, at the time when he should have been notified.

in October, 1921. The taxpayer contended that, having paid the tax assessable as of April 1, 1920, it has paid for the privilege of doing business during that calendar year; that to assess a further tax was either to tax it twice for the same privilege (doing business in 1920) or once for a privilege which it never could or did exercise (doing business in 1921). The Massachusetts court held that the second tax was rightly assessed. Chief Justice Rugg explained:

"This tax is a single excise * * *. Although both property and income are used as a basis for its calculation, the tax is nevertheless an excise on the commodity of exercising the corporate franchise * * *. The tax here assailed was levied in respect to the doing of business during the calendar year beginning January 1, 1920. This is the plain effect of said chapter 355. That act was approved on July 24, 1919. By section 33 it went into effect on January 1, 1920. The first return under the act was required to be filed by the corporation during the first 10 days of April, 1920, as of the 1st day of that April. (Section 4.) The items of that return included the corporate excess as of that 1st day of April and the 'net income for the taxable year as required to be reported by the corporation in its last prior return to the Federal Government.' (Section 3.) That 'last prior return' was and of necessity must have been for the calendar year 1919. The next excise tax, being that here in question, was levied in respect to the doing of business during the calendar year beginning with January 1, 1920. This part of the excise is levied for a period of time which is past and not for a period in the future. The effect of that statute was to impose an excise for the commodity of carrying on business by a domestic corporation for a less period than one year in cases where such business was not carried on for an entire year * * *.

"The petitioner enjoyed the commodity of carrying on business as usual until July 29, 1920 * * *. These corporate activities are legally subject to an excise * * *."

What the court meant by describing the tax as a "single excise" was that the tax, though made up of two components, was levied on a single commodity, that is, the exercise of the corporate franchise during the calendar year preceding the April 1st as of which the corporate excess was calculated. That these two components in truth were separable was demonstrated by what happened in the Springdale case itself; the tax there sustained was based solely on the net income of the corporation earned during the early months of 1920 before it went out of business.

It becomes apparent that that portion of the tax claimed as a deduction by the taxpayer in the present case, although paid during 1921, was exacted for the privilege of doing business during 1920 and that it became an inescapable liability during that year. The corporation could, of course, have escaped payment of that part of the tax calculated on its "corporate excess" had it dissolved prior to April 1, 1921; and at any rate the amount of this factor could not be determined until that date. No such choice was open in regard to that part of the tax determined by the taxpayer's net income; as of December 31, 1920, the amount of excise to be paid under this factor became mathematically ascertainable and its ultimate payment inevitable. (*Springdale Finishing Co.* v. *Commonwealth*, 242 Mass., 37 (1922); *Commonwealth of Massachusetts* v. *Meehan*, 67 Fed. (2d), 638 (C. C. A. 1, 1933).)

The Supreme Court has had occasion to define the requirements of "accrual" of taxes. In *United States* v. *Anderson* (269 U. S., 422 (1926) [T. D. 3839, C. B. V-1, 179 (1926)]), the taxpayer had attempted to deduct the munitions tax[6] from his gross income for 1917. The munitions tax was calculated on a basis of the taxpayer's 1916 gross income, but was not "assessed" and did not become "due" until much later in 1917. In holding that the deduction should have been taken in 1916, Mr. Justice Stone said (pages 440-441):

"Only a word need be said with reference to the contention that the tax upon munitions manufactured and sold in 1916 did not accrue until 1917. In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of a taxpayer to pay it. In this respect * * * the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books."

To the same effect, see *American National Co.* v. *United States* (274 U. S., 99 [T. D. 4099, C. B. VI-2, 193 (1927)]); *Niles Bement Pond Co.* v. *United States*

[6] Revenue Act of 1916, sections 300 et seq. (39 Stat., 780).

(281 U. S., 357 [Ct. D. 185, C. B. IX-1, 295 (1930)]); *Aluminum Castings Co.* v. *Routzahn* (282 U. S., 92 [Ct. D. 270, C. B. X-1, 352 (1931)]). Cf. *Fawcus Machine Co.* v. *United States* (282 U. S., 375 [Ct. D. 278, C. B. X-1, 424 (1931)]).

We think that the deduction sought by the present appellant, representing taxes exacted for the privilege of doing business in 1920 and ascertainable in that year, was a proper deduction from 1920 gross income and should have been allowed. In the case of a taxpayer whose books are kept on an accrual basis, "while the taxes for any year are not payable until the following year, good accounting practice requires an accrual of them as a liability of the current year's business. * * * A corporation can not claim to have accumulated any net income in any year until provision is made for taxes accrued, based on net income for the same year." (*Fawcus Machine Co.* v. *United States*, 282 U. S., 375, 378.) Had the Massachusetts law provided for two formally separate taxes, each calculated on a basis of one of the factors, there could be no doubt in view of the Anderson case that that tax based on 1920 net income "accrued" in 1920. We can see no reason why the formally composite nature of the excise should necessitate a contrary result. The fact that a further indefinite impost may be levied is scarcely a valid reason for refusing to permit the accrual of that which is already certain.

The Massachusetts Department of Corporations and Taxation has consistently ruled that the income portion of the Massachusetts domestic corporation tax becomes a liability of the taxpayer in the year in which the income is earned and has always permitted the accrual of that amount in that year. A close analogy may be found in a ruling by the General Counsel for the Internal Revenue Bureau that one-tenth of the Federal social security tax,[1] which is calculated as a percentage of wages paid by the employer, is to be accrued during the period when the wages are paid. The other nine-tenths of the same excise can not be accrued until later, since the taxpayer's liability is dependent upon a certification of the State law which might create a credit up to nine-tenths of the total tax. (G. C. M. 19692, C. B. 1938-1, 148.) It seems clear, therefore, that the formal unity of a presently uncertain tax does not prevent the accrual of any portion of it as of the time that portion becomes certain.

We are aware of authority which would suggest a decision contrary to ours, but we do not consider it persuasive since it apparently results from a fundamental misconception of the Massachusetts corporation excise law. In *H. H. Brown Co.* (8 B. T. A., 112 (1927)), the taxpayer sought to accrue its entire Massachusetts domestic corporation tax, assessable as of April 1, on the ensuing June 30, the close of its accounting year. The Board held that this was permissible. While the holding is not precisely in point, it might follow as a corollary that an earlier accrual of a portion of the tax would have been regarded as improper. At any rate, the Board based its decision upon the assumption that "The corporation excise tax * * * is assessed as of April 1 of the taxable year"—a statement which is erroneous in view of the Springdale decision which determined the "taxable year" to be the Federal income tax year preceding the April 1 assessment date. (Cf. *National Casket Co., Inc.*, 29 B. T. A., 139 (1933), rev'd in part, 78 Fed. (2d), 940 (C. C. A. 3, 1935) [Ct. D. 1097, C. B. XV-1, 243 (1936)].) That the Board might have reached a decision agreeing with ours had not its construction of the Massachusetts statute been erroneous, is indicated by its exposition of the applicable principles: "The basic idea under the accrual system of accounting is that the books shall immediately reflect obligations and expenses definitely incurred and income definitely earned without regard to whether payment has been

[1] 42 U. S. C., sections 1101, et seq. (49 Stat., 639, sections 901 et seq.).
Provisions for credit against the tax are as follows:
SEC. 902. [Credit against tax.] The taxpayer may credit against the tax imposed by section 901 the amount of contributions, with respect to employment during the taxable year, paid by him (before the date of filing his return for the taxable year) into an unemployment fund under a State law. The total credit allowed to a taxpayer under this section for all contributions paid into unemployment funds with respect to employment during such taxable year shall not exceed 90 per centum of the tax against which it is credited, and credit shall be allowed only for contributions made under the laws of States certified for the taxable year as provided in section 903.
SEC. 903. [Approval and certification of State laws.] (a) The Social Security Board shall approve any State law submitted to it, within 30 days of such submission, which it finds provides that [certain specified criteria are complied with] * * *
(b) On December 31 in each taxable year the Board shall certify to the Secretary of the Treasury each State whose law it has previously approved, except that it shall not certify any State which, after reasonable notice and opportunity for hearing to the State agency, the Board finds has changed its law so that it no longer contains the provisions specified in subsection (a) or has with respect to such taxable year failed to comply substantially with any such provisions.

made or whether payment is due. Expenses incurred in the operations for a particular year are properly accrued in the accounts for that year, although payment may not be due until the following year. Under the accrual system, the word 'accrued' does not signify that the item is due in the sense of being then payable. On the contrary, the accrual system wholly disregards due dates." (8 B. T. A., at page 117.) It seems clear to us that the deduction sought in the present case was an expense "incurred in the operations for" 1920 and was therefore "properly accrued in the accounts for that year."

A second apparently contrary ruling is found in G. C. M. 6616 (C. B. IX–2, 335 (1930)). There a taxpayer sought to accrue the total Massachusetts domestic corporation taxes, payable in 1921 and 1922, during its fiscal year ending March 31, 1922. Naturally it was held that such an accrual was improper. The memorandum decided, however, that each tax should be considered as a unit. It therefore allowed a deduction of the entire tax payable in 1921 from the taxpayer's gross income for the taxable year April 1, 1921, to March 31, 1922; and it permitted a similar deduction in the following year. It does not appear that the taxpayer argued for separate consideration of the two factors comprising the Massachusetts domestic corporation tax.[8]

The Massachusetts domestic corporation law was amended in 1927 so that valuation of the "corporate excess" was to be made as of the close of the corporation's taxable year. (Massachusetts Acts and Resolves, 1927, ch. 258, section 3, amending General Laws, ch. 63, section 32.) Since 1927, therefore, both factors of the excise tax have become calculable simultaneously. Under the law as amended it has been ruled that the entire tax may be accrued against the gross income of the year at the close of which the tax is calculated. (G. C. M. 8553, C. B. IX–2, 109 (1930). We need have no fear, therefore, that our present decision, dealing as it does with income tax returns prior to 1927, will affect current Treasury practice.

The decision of the district court is reversed, and the case is remanded to that court with directions to enter judgment for the plaintiff in accordance with the stipulation.

ARTICLE 23(c)–1: Taxes (Also Section 41, Article 41–3.)

1941–8–10612
G. C. M. 22525

REVENUE ACTS OF 1921, 1924, 1926, 1928, AND 1932.

A corporation keeping its accounts on the accrual basis and filing its returns on the calendar year basis was entitled to accrue and deduct for the year 1920 that part of the Massachusetts excise tax on corporations (adopted in the year 1919) which is based upon its net income for Federal income tax purposes for the year 1920, even though the other part of the tax, based on "corporate excess" as of April 1, 1921, could not be accrued and deducted until the year 1921.

In view of the amendment of the Massachusetts law in 1927, effective January 1, 1928, a corporation keeping its accounts on the accrual basis and filing its returns on the calendar year basis was entitled to deduct for the year 1928 the Massachusetts excise tax on corporations which accrued as of January 1, 1928, and as of December 31, 1928.

G. C. M. 6616 (C. B. IX–2, 335 (1930)) revoked.

G. C. M. 8553 (C. B. IX–2, 109 (1930)) modified to accord with the reasoning of the court in the case of *Colton Elastic Web Co.*, v. *United States*, decided December 9, 1940 (Ct. D. 1490, page 346, this Bulletin).

An opinion is requested whether, in view of the decision of the United States Circuit Court of Appeals for the First Circuit, dated

[8] The persuasive force of the memorandum is somewhat lessened by its misquotation of the Springdale case, which resulted in a misapprehension of the Massachusetts court's definition of "taxable year." In the paragraph of the Springdale decision set forth above, the memorandum misquotes the original text (referring to "the next excise tax") by speaking of "the *net* excise tax." The result is to confuse the discussion of the tax litigated in the suit with the discussion of that tax already paid, the propriety of which was unquestioned.

December 9, 1940, in *Colton Elastic Web Co.* v. *United States*, relating to the accrual and deductibility of the Massachusetts corporation excise tax for the year 1920, G. C. M. 6616 (C. B. IX-2, 335 (1930)) and G. C. M. 8553 (C. B. IX-2, 109 (1930)) should be revoked or modified.

The Massachusetts corporation excise tax, adopted in 1919, which is a tax on the privilege of carrying on or doing business, is computed by adding together a percentage of the "corporate excess" determined as of April 1 and a percentage of the corporation's net income as reported to the Federal Government on its last income tax return prior to April 1. The court in its opinion in the above-cited case was concerned with the accrual and deduction for Federal income tax purposes of that part of the State tax based upon net income of the corporation. The court held that the appellant corporation, being on a calendar year basis, was entitled to accrue and deduct for the year 1920 that part of the tax which was based upon its net income for that year for Federal income tax purposes, even though the other part of the tax, based on the "corporate excess" as of April 1, 1921, could not be accrued and deducted until the calendar year 1921. The court cited the case of *Springdale Finishing Co.* v. *Commonwealth* (242 Mass., 37; 136 N. E., 250) wherein the Massachusetts tax was characterized as a "single tax," and explained this reference to mean that the tax, although made up of two components, was a tax on a single commodity, that is, the exercise of the corporate franchise during the year preceding the April 1st as of which the "corporate excess" was calculated, and not to mean that the tax was a single indivisable tax.

In G. C. M. 6616, supra, the Springdale case was interpreted as holding that the Massachusetts tax, although made up of two separate parts, was a single indivisible tax. Accordingly, it was held that the tax, as a whole, must be accrued as of April 1. The court, in referring to G. C. M. 6616, stated that "It does not appear that the taxpayer argued for separate consideration of the two factors comprising the Massachusetts domestic corporation tax." The conflict between G. C. M. 6616 and the opinion of the court as to the nature of the Massachusetts tax appears to have resulted from divergent interpretations of the Springdale case.

The Massachusetts corporation excise tax law was amended in 1927, effective January 1, 1928, so that the valuation of the "corporate excess" was to be made as of the close of the corporation's taxable year. Accordingly, G. C. M. 8553, supra, held that a corporation on the calendar year basis could deduct for the year 1928 the Massachusetts excise tax which accrued as of January 1, 1928, and as of December 31, 1928. In view of the change in the Massachusetts law, the conclusion reached in G. C. M. 8553 is consistent with the opinion of the Circuit Court of Appeals for the First Circuit, but the reasoning, in so far as it follows that contained in G. C. M. 6616, conflicts therewith.

In view of the foregoing, G. C. M. 6616, supra, is revoked, and G. C. M. 8553, supra, is modified to accord with the reasoning of the court in *Colton Elastic Web Co.* v. *United States*, supra.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

ARTICLE 23(c)-1: Taxes. 1941-15-10677
(Also Section 41, Article 41-3.) G. C. M. 22636

REVENUE ACT OF 1928.

Iowa real property taxes accrue for Federal income tax purposes in September, when they are levied by the board of supervisors and when the amount of the tax is finally determined. G. C. M. 9793 (C. B. X-2, 142 (1931)) modified.

An opinion is requested whether G. C. M. 9793 (C. B. X-2, 142 (1931)) should be modified in view of the decision of the Board of Tax Appeals in the case of *Lowell H. Chamberlain et ux.* v. *Commissioner* (43 B. T. A., 259, acquiescence, page 2, this Bulletin).

In G. C. M. 9793, supra, it was held that real property taxes in the State of Iowa accrue for Federal income tax purposes as of January 1 of each year, which is the date as of which the taxes are assessed.

In the Chamberlain case, it was held that real property taxes in Iowa accrue in September, when they are levied by the board of supervisors and when the amount of the tax is finally determined, at which time, under decisions of the Supreme Court of Iowa, the tax first becomes a lien or obligation against the land. (See *Gates* v. *Wirth*, 181 Ia., 19; 163 N. W., 215. Also compare *Iowa Wesleyan College* v. *Knight*, 207 Ia., 1238; 224 N. W., 502.)

The State of Iowa is in the jurisdiction of the United States Circuit Court of Appeals for the Eighth Circuit, which in *Lifson et al.* v. *Commissioner* (98 Fed. (2d), 508, Ct. D. 1409, C. B. 1939-2, 198) took the position that the accrual date of Minnesota real property taxes is the date on which the lien for such taxes attaches to the land. Accordingly, acquiescence has been entered in the case of *Lowell H. Chamberlain* v. *Commissioner*, supra. The decision in the Chamberlain case, however, will not be followed generally with respect to the accrual date of State property taxes, but will be confined in its application to cases involving the accrual date of Iowa real property taxes. G. C. M. 9793, supra, is modified to accord with the views expressed herein.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

SECTION 23(e).—DEDUCTIONS FROM GROSS INCOME: LOSSES BY INDIVIDUALS.

ARTICLE 23(e)-1: Losses by individuals.

REVENUE ACT OF 1932.

Deductibility of difference between value of lease canceled and consideration received for the cancellation. (See Ct. D. 1502, page 319.)

SECTION 23(m).—DEDUCTIONS FROM GROSS INCOME: DEPLETION.

ARTICLE 23(m)-1: Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.

REVENUE ACT OF 1934.

Meaning of the word "property." (See G. C. M. 22106, page 245.)

ARTICLE 23(m)-1: Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.

REVENUE ACT OF 1934 AND PRIOR REVENUE ACTS.

Status of oil and gas leasing transactions. (See G. C. M. 22730, page 214.)

ARTICLE 23(m)-9: Determination of mineral contents of mines and of oil or gas wells.

REVENUE ACTS OF 1934 AND 1932.

Regulations 86 and 77, amended. (See T. D. 5054, page 227.)

PART IV.—ACCOUNTING PERIOD AND METHODS OF ACCOUNTING.

SECTION 41.—GENERAL RULE.

ARTICLE 41-3: Methods of accounting.

REVENUE ACTS OF 1921, 1924, 1926, 1928, AND 1932.

Accrual of Massachusetts excise tax on corporations. (See G. C. M. 22525, page 350.)

ARTICLE 41-3: Methods of accounting.

REVENUE ACT OF 1928.

Iowa real property taxes—date of accrual. (See G. C. M. 22636, page 352.)

SECTION 42.—PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

ARTICLE 42-1: When included in gross income. 1941-15-10678
Ct. D. 1500

INCOME TAX—REVENUE ACT OF 1934—DECISION OF SUPREME COURT.

1. GROSS INCOME—METHOD OF ACCOUNTING—ACCRUAL OF DECEASED PARTNER'S SHARE OF PROFITS EARNED BUT NOT RECEIVED.

When both the decedent and the law partnership of which he was a member reported income on a cash receipts and disbursements basis, the decedent's share of partnership profits earned but not yet received, consisting of uncollected accounts and unfinished work, may be included in gross income as accruable items for the period ending with his death, under the provisions of section 42 of the Revenue Act of 1934.

2. DECISION REVERSED.

Decision of the United States Circuit Court of Appeals, Third Circuit [1940] (112 Fed. (2d), 919), reversing memorandum opinion of the United States Board of Tax Appeals [1939], reversed.

SUPREME COURT OF THE UNITED STATES.

Guy T. Helvering, Commissioner of Internal Revenue, petitioner, v. Estate of John M. Enright, Deceased, James G. Enright, Emma B. Neilson, and Mildred L. Enright, Executors.

[61 S. Ct. 777.]

On writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit.

[March 31, 1941.]

OPINION.

Mr. Justice REED delivered the opinion of the Court.

Certiorari was granted to review the judgment below[1] because of a conflict between it and *Pfaff* v. *Commissioner*[2] in the Second Circuit. The issue is whether section 42 of the Revenue Act of 1934[3] permits the inclusion, as accruable items, in a decedent's gross income for the period ending with his death of his share of the profits earned, but not yet received, of a partnership, when both the decedent and the partnership reported income on a cash receipts and disbursements basis.

Respondents are the executors of John M. Enright, an attorney and member of a law partnership in New Jersey. Both Mr. Enright and his firm kept their accounts and made their income tax report on a calendar year cash receipts and disbursements basis. He died, testate, November 19, 1934. The partnership agreement provided for the termination of the partnership on the death of any partner and that his estate should have his partnership percentage in the "net moneys then in the treasury of the firm, plus his like percentage in the outstanding accounts and the earned proportion of the estimated receipts from unfinished business." The will directed that the valuation for the purpose of closing out the partnership should be made by his senior surviving partner, Mr. James D. Carpenter, and by agreement between Mr. Carpenter and the executors a valuation was made of these items as of the date of death for use in the Federal estate tax and New Jersey inheritance tax returns, with the further understanding that the surviving partners would pay over to the executors whatever was ultimately realized out of the valued assets.

Pursuant to this arrangement the interest of Mr. Enright in the uncollected accounts was valued at $2,055.55 and in the unfinished work at $40,855.77. These sums were reported as assets in the estate and inheritance tax returns but were not included in the income tax return made for the decedent for 1934 nor were the sums derived from these assets reported in the estate's income tax for 1934 or later years.

The Commissioner assessed a deficiency because he included in the decedent's return for 1934, under the claimed authority of section 42, supra note 3, the items of accounts and unfinished work. Respondents appealed to the Board of Tax Appeals. The Board decided[4] that the evidence did not show the situation of the unfinished work in sufficient detail to enable the Board to determine independently that it was not accruable. The accounts receivable were held accruable. This left the Commissioner's assessment intact.

On appeal the circuit court of appeals reversed the Board. It was of the opinion that the partnership was a tax computing unit separate from its members and that section 42 had the effect of placing the decedent "upon an accrual basis at the date of his death." Consequently his return should be made as it would have been made if the deceased used the accrual method. The court then reasoned that the requirement of section 182 of the Revenue Act of 1934, including a partner's distributive share of the partnership earnings, whether distributed or not, in the partner's computation of his own net income, put a partner on an accrual basis in accounting for partnership earnings, irrespective of section 42.

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[1] 112 Fed. (2d), 919.

[2] 113 Fed. (2d), See *Pfaff* v. *Commissioner*, No. 479 this term, decided to day [Ct. D. 1501, page 357, this Bulletin].

[3] 48 Stat., 680, ch. 277: "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."

[4] August 28, 1939, by memorandum opinion. (Cf. *Lillian O. Fehrman, Executrix*, 38 B. T. A., 37.)

Consequently section 42 was held not to affect the partnership accounting practices. It was further determined that it was the right to receive payment which made an earning accrue and that as Mr. Enright under the partnership agreement had no right to receive anything from the firm except his proportionate share of the cash receipts, these cash receipts were all that "accrued" to him before his death.

The last sentence of section 42 which requires the inclusion of "amounts accrued up to the date of his death" in computing net income for the period in which his death falls was added by the 1934 Revenue Act.[5] The reports recommended its addition because the "courts have held that income accrued by a decedent on the cash basis prior to his death is not income to the estate, and under the present law, unless such income is taxable to the decedent, it escapes income tax altogether."[6] So section 42 was drawn to require the inclusion of all amounts accrued to the date of death "regardless of the fact that he may have kept his books on a cash basis."[7] With the declared purpose of Congress in mind, we proceed to examine the meaning of the section.

As the questioned items of unfinished work appear in the partnership accounts, we must determine whether such earnings, even if accruable, are includible in the partner's return for 1934. Respondent argues, as the circuit court of appeals held, that section 182[8] accrues, without any effect from the language of section 42, all the earnings that are includible in a partner's return, and that since the partnership method of keeping its books did not treat unfinished business as receipts, only the earnings actually collected are a part of the partner's distributive share under section 182.

We think such a conclusion is erroneous. The partnership agreement and the subsequent arrangement between the executors and the surviving partners called for a valuation on Mr. Enright's death and a dissolution as of that day. This necessitated an accounting of partnership earnings for this period. By the terms of the agreement, as would have been necessary anyway, the earned proportion of the unfinished business was to be valued to determine the decedent's interest in the partnership assets.[9] Assuming at this point that the unfinished business is accruable, this accounting as of the time of death would show the partnership income for the taxable year of the partnership.[10] As the net income of the partnership is to be accounted for in the deceased partner's return, without consideration of the period over which the income is earned, the fact that the payment for the unfinished business will not be collected until another taxable year is immaterial. "Circumstances wholly fortuitous may determine the year in which income, whenever earned, is taxable."[11] The "distributive share" referred to in

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[5] Cf. Revenue Act of 1932 (47 Stat., 169, ch. 209, section 42).

[6] H. Rept. No. 704, Seventy-third Congress, second session, page 24; S. Rept. No. 558, Seventy-third Congress, second session, page 28.

This situation followed the decision of the Court of Claims in *Nichols* v. *United States* (64 Ct. Cl., 241). A decedent on the cash basis was a member of a partnership dissolved by his death. Commissions earned before death but unpaid to the partnership were valued in the estate tax and collected by the partnership after death for payment to the executors. The Court of Claims held sums paid the executors were part of the corpus and not income.

The Board of Tax Appeals followed the reasoning of the Court of Claims. (*William G. Frank, Adm.*, 6 B. T. A., 1071; *E. S. Heller, Exec.*, 10 B. T. A., 53; *George Nichols et al., Exec.*, 10 B. T. A., 919; *Estate of A. Plumer Austin*, 10 B. T. A., 1055; *William K. Vanderbilt, Exec.*, 11 B. T. A., 291; *J. Howland Auchincloss, Exec.*, 11 B. T. A., 947; *William P. Blodget et al., Exec.*, 13 B. T. A., 1243; *Jackson B. Kemper, Adm.*, 14 B. T. A., 931; *Maurice L. Goldman*, 15 B. T. A., 1341.)

[7] H. Report, supra.

[8] SEC. 182. TAX OF PARTNERS.

There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year.

[9] We do not consider or decide whether this accounting for a fractional year may affect the individual returns of surviving partners. Neither do we appraise the effect of agreements for continuation of an interest in the partnership after death. (See *Bull* v. *United States*, 295 U. S., 247 [Ct. D. 969, C. B. XIV–1, 310 (1935)].)

If the partnership had been upon an accrual basis which treated accounts as accrued upon a determination of the amount of fees, it may be that a decedent's interest would not be distributable until a later year. It might then be income to the estate, even though the value of the right to receive it was included in the estate return. A conclusion as to this is unnecessary and is pretermitted. (Cf. note 23, the cases cited in note 6 and *Bull* v. *United States*, 295 U. S., 247, 255, 256–257.)

[10] SEC. 48. DEFINITIONS.

When used in this title—

(a) TAXABLE YEAR.—"Taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part. "Taxable year" includes, in the case of a return made for a fractional part of a year under the provisions of this title or under regulations prescribed by the Commissioner with the approval of the Secretary, the period for which such return is made.

[11] *Guaranty Trust Co.* v. *Commr.* (303 U. S., 493, 498 [Ct. D. 1327, C. B. 1938–1, 258]).

section 182 does not mean available in cash for payment to the partner. It means only that gains attributable to the partner's interest in the firm were earned. Partnership returns may be made on a different basis of computation than those of the members.[12] Thus because of the partnership arrangement and agreement, the value of the unfinished business must be determined as of the date of death. Further the result, under the assumption here that it is an accrual, is a distributive share and is to be carried into the partner's return. Respondent's argument that the requirement of section 182, including all distributable shares in the partner's return, puts all partnership returns on the accrual basis fails to give weight to the fact that a partnership on the cash method shows only cash receipts as a partner's distributive share. The requirement to account for a distributive share, although the share is actually not distributed, is not a requirement to account for partnership income on an accrual basis. Since a partner's return of his partnership earnings would vary, dependent upon whether the partnership used the cash or accrual method of accounting, we do not agree with respondent's suggestion.

We turn now to whether this valuation of the decedent's interest in the partnership is an accrual of income which must be reflected in the income tax or a valuation of assets only reflected in estate or inheritance reports. This partnership uses the cash receipts method. There was no customary accounting system to determine whether the value of services rendered should be accrued before payment. Under such circumstances, we are of the view that items of partnership income properly accrued should be included in the income tax return of the deceased partner. This will cause the accrued items of partnership returns to be included in the income tax return of a deceased partner, whether the partnership method is accrual or cash.[13] Furthermore, an accrual of compensation for the unfinished business seems sound in view of the purpose of the enactment of section 42.

The meaning of "amounts accrued up to the date of his death" is clear as to fixed rent, interest, salary or wages for personal services and other similar income which may readily be attributed to a particular period. There are like deductions such as interest and taxes.[14] The uncertainty as to the meaning arises in the field of personal service from items which can not be accounted for on a basis of successive equal units of time. Examples of the difficulty are the value, prior to a successful result, of services rendered on a contingent basis, done on a quantum meruit whether that would or would not vary with the outcome, or exploratory or preliminary steps looking towards final accomplishment.

While "accrue" and its various derivatives are not new to the nomenclature of accounting or taxation, its use has not sufficed to build it into a word of art with a definite connotation when employed in describing items of gross income. The 1913 Act[15] put the taxpayer on an actual cash receipt and disbursement basis. The 1916 Act[16] gave the taxpayer the option of reporting on either the cash or accrual basis and the 1918 Act limited the return to the method of accounting regularly employed unless otherwise directed by the Commissioner of Internal Revenue.[17] A similar provision covers the year here in question.[18] That the meaning to be attributed to "accrued" as used in section 42 is to be gathered from its surroundings is emphasized by section 48, Definitions, which says:

"(c) PAID, INCURRED, ACCRUED.—The terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part."[19]

It is to be noted that no change was made by the 1934 Act in the section 48 definition of "accrued."[20] Yet, it is obvious that the definition is inapplicable since a taxpayer on a cash basis can not have a "method of accounting" by which the meaning of accrual is fixed. Consequently it is beside the point to give weight to provisions of the regulations or accounting practices which do not

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[12] *Truman* v. *United States* (4 Fed. Supp., 447; sections 183 and 187).
[13] The inevitable variations of "accrued" which depend upon established accounting practice do not destroy the principle.
[14] Cf. *United States* v. *Anderson* (269 U. S., 422 [T. D. 3839, C. B. V-1, 179 (1926)]).
[15] 38 Stat., 114 at 166.
[16] 39 Stat., 756, sections 8(g) and 13(d).
[17] 40 Stat., 1057, section 212(b).
[18] 48 Stat., 680, section 42.
[19] Cf. *Ernest M. Bull, Exec.* (7 B. T. A., 993, 995).
[20] Cf. section 48(c) of the Revenue Act of 1932 (47 Stat., 188).

recognize accruals until a determination of compensation.[21] Such provisions when applied bring the income into succeeding years. It has been frequently said, and correctly, that section 42 was aimed at putting the cash receipt taxpayer on the accrual basis.[22] But that statement does not answer the meaning of accrual in this section. Accounts kept consistently on a basis other than cash receipts might treat accruals quite differently from a method designed to reflect the earned income of a cash receipt taxpayer. Accruals here are to be construed in furtherance of the intent of Congress to cover into income the assets of decedents, earned during their life and unreported as income, which on a cash return, would appear in the estate returns. Congress sought a fair reflection of income.[23]

Accrued income obviously connotes more than interest. In *United States* v. *American Can Co.*,[24] this Court approved an accrual basis where "pecuniary obligations to or by the company were treated as if discharged when incurred." In *United States* v. *Anderson*[25] accruals of fixed annual charges, e. g., taxes payable in another year, were permitted against determinable gross income. "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income."[26] The completion of the work in progress was necessary to fix the amount due but the right to payment for work ordinarily arises on partial performance. Accrued income under section 42 for uncompleted operations includes the value of the services rendered by the decedent, capable of approximate valuation whether based on the agreed compensation or on quantum meruit. The requirement of valuation comprehends the elements of collectibility.[27] The items here meet these tests and are subject to accrual.

The judgment of the circuit court of appeals is reversed and the decision of the Board of Tax Appeals affirmed.

ARTICLE 42–1: When included in gross income. 1941–15–10679 Ct. D. 1501

INCOME TAX—REVENUE ACT OF 1934—DECISION OF SUPREME COURT.

1. GROSS INCOME—METHOD OF ACCOUNTING—ACCRUAL OF DECEASED PARTNER'S SHARE OF PROFITS EARNED BUT NOT RECEIVED.

The fair value of a deceased partner's interest in the accounts of a medical partnership were includible in his gross income for the period ending with his death in 1935, under the provisions of section 42 of the Revenue Act of 1934 and article 42(1) of Regulations 86, where the decedent and the partnership were on a cash basis.

2. DECISION FOLLOWED.

Helvering v. *Estate of John M. Enright* [Ct. D. 1500, page 13, this Bulletin] followed.

3. DECISION AFFIRMED.

Decision of the United States Circuit Court of Appeals, Second Circuit [1940] (113 Fed. (2d), 114), affirming memorandum opinion of the United States Board of Tax Appeals [1939], affirmed.

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[21] Regulations 86, article 42–1.

[22] *Lillian O. Fehrman, Exec.* (38 B. T. A., 37); *Estate of Wilton J. Lambert* (40 B. T. A., 802, 806); *Estate of G. Percy McGlue* (41 B. T. A., 1186, 1193); *Enright* v. *Commissioner* (112 Fed. (2d), 919), this case below.

[23] It is immaterial that all possibility of escaping an income tax is not barred, as for instance the increased value of asset items in an estate return. Act, 113(a)(5) "* * * the entire field of proper legislation [need not] be covered by a single enactment." (*Rosenthal* v. *New York*, 226 U. S., 260, 271; cf. *Keokee Coke Co.* v. *Taylor*, 234 U. S., 224, 227).

[24] 280 U. S., 412, 417 [Ct. D. 164, C. B. IX–1, 202 (1930)].

[25] 269 U. S., 422, 437 [T. D. 3839, C. B. V–1, 179 (1926)].

[26] *Spring City Co.* v. *Commr.* (292 U. S., 182, 184 [Ct. D. 829, C. B. XIII–1, 281 (1934)]); *Guaranty Trust Co.* v. *Commr.* (303 U. S., 493, 498).

[27] Cf. Parlin, Accruals to Date of Death (87 U. of Pa. L. Rev., 294, 301); Farrand & Farrand, Treatment of Accrued Items on Death (13 So. Cal. L. Rev., 431).

SUPREME COURT OF THE UNITED STATES.

Norman J. Pfaff and Frank B. Wallace, Executors of the Estate of William L. Wallace, Deceased, petitioners, v. *Commissioner of Internal Revenue.*
[61 S. Ct., 783.]

On writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[March 31, 1941.]

OPINION.

Mr. Justice REED delivered the opinion of the Court.

This case presents the same question as *Helvering* v. *Enright*, decided to-day [Ct. D. 1500, page 353, this Bulletin]. Petitioners are the executors of a deceased physician who during 1935 was a member of a medical partnership and entitled to 40 per cent of its profits. He died December 25, 1935, on which date there were outstanding about $69,000 of partnership accounts receivable for services rendered to patients during his lifetime. His death worked a dissolution of the partnership under section 62(4) of the New York Partnership Law. The decedent's interest in these accounts came to over $27,000. Both he and the partnership were on a cash basis. Pursuant to section 42 of the Revenue Act of 1934 and article 42(1) of Treasury Regulations 86, the Commissioner included the decedent's share of the accounts receivable in his 1935 income, though only at about one-fifth of face value. The Board of Tax Appeals sustained the Commissioner's view of the statute, and also ruled that the valuation of the decedent's interest in the accounts at one-fifth of face value was amply supported. The circuit court of appeals, without writing an opinion, affirmed the Board. (113 Fed. (2d), 114.) Because of a conflict with the Third Circuit's decision in the Enright case, supra, we granted certiorari.

There is no relevant difference between these facts and *Helvering* v. *Enright*. For the reasons stated in that opinion it was proper to include in the decedent's 1935 income the fair value of his interest in the accounts.

Affirmed.

SECTION 45.—ALLOCATION OF INCOME AND DEDUCTIONS.

ARTICLE 45-1: Determination of the taxable net income of a controlled taxpayer. 1941-23-10733 Ct. D. 1514

INCOME TAX—REVENUE ACT OF 1934—DECISION OF COURT.

1. INCOME—DEDUCTIONS—ALLOCATION—LOSS ON SALE OF STOCK ACQUIRED FROM CORPORATION UNDER COMMON CONTROL WITH TAXPAYER.

In 1934 the X Corporation sold through a broker certain stock which it had acquired in 1931 in a transaction with Y Corporation, which was wholly owned and controlled by an individual who was the sole stockholder and owner of X. At the time of acquisition the stock was entered on X's books at the original cost to Y, which was much greater than the fair market value of the stock at that date. *Held:* The action of the Commissioner was not arbitrary or capricious in using the fair market value of the stock on the date of acquisition, rather than the original cost to Y, as a basis for allocating to the X Corporation the amount of deduction for loss sustained on the sale. The question of what is actual cost is to be determined by the Commissioner as a matter of fact, and he is given a wide latitude under section 45 of the Revenue Act of 1934 in making such determination.

2. CASE FOLLOWED IN PRINCIPLE.

Asiatic Petroleum Co. v. *Commissioner* (1935) [Ct. D. 1105, C. B. XV–1, 181 (1936)] (79 Fed. (2d), 234) followed in principle.

3. DECISION AFFIRMED.

Decision of the United States Board of Tax Appeals (1940) (41 B. T. A. 223) affirmed.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

G. U. R. Co., petitioner, v. *Commissioner of Internal Revenue, respondent.*
[117 Fed. (2d), 187.]

Petition for review of decision of the United States Board of Tax Appeals.

Before EVANS and SPARKS, Circuit Judges, and LINDLEY, District Judge.

[January 17, 1941.]

OPINION.

SPARKS, Circuit Judge: Appellant petitioned for review of a proposed deficiency in income tax liability for the year 1934. The deficiency was due to reduction in a capital loss sustained on the sale of 300 shares of American Superpower Co. stock. Respondent, under section 45 of the Revenue Act of 1934,[1] made his determination on the basis that the stock had been acquired from a company under common control with petitioner. The Board of Tax Appeals sustained the respondent's ruling, and determined petitioner's income tax for 1934 to be $2,713.59.

The question presented is whether the action of the Commissioner was arbitrary or capricious, in allocating to the taxpayer the amount of $804.76, as a deduction from gross income, rather than $7,159.51 claimed by the taxpayer.

The Board found the facts to be as follows: George Uihlein was the sole stockholder of the taxpayer and of the Oakwood company, both of which were under his control. In 1934 the taxpayer, through a broker, sold 300 shares of the Superpower company stock for $263.99. In its return for 1934, taxpayer claimed a loss of $7,159.51 by reason of this sale, being the difference between the alleged cost of the stock and its sale price. This stock was part of 1,500 shares of the Superpower company which had been acquired by the taxpayer in a transaction with the Oakwood company on December 28, 1931. The 1,500 shares had been placed on taxpayer's books at a cost to it of $37,117.50, which was the original cost of this stock to Oakwood. However, the fair market value of 300 shares of that stock on the date of transfer to the taxpayer was $1,068.75.

On this date the taxpayer had a maturing loan of $100,000 at the Marine National Exchange Bank of Milwaukee. Its portfolio of securities on that date had a market value of $91,075 which with its cash of $4,060.05 constituted its only liquid assets, making a total of $95,135.05. Its only other asset at that time was an open account advance to the Oakwood company of $929,644.40, and its only other liability was an advance from Uihlein, its sole stockholder, of $561,687.08.

In order to present an acceptable bank statement and to obtain liquid assets in excess of its bank loan, the taxpayer purchased securities from Oakwood, including the stock here involved. These securities were figured at Oakwood's cost of $369,654.90, and Oakwood assumed the taxpayer's debt to Uihlein of $561,687.08. The total of these figures exceeded Oakwood's debt to taxpayer of $929,644.40 by $1,697.58, which was paid to Oakwood on the same day by taxpayer's check. This transaction in effect canceled Oakwood's account owing to

[1] SEC. 45. 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.

taxpayer, rendered all of taxpayer's assets liquid, and protected taxpayer on all of its obligations except that to the bank.

On the same day, after the transaction, taxpayer renewed its note at the bank. Both the renewal note and the maturing note were collateral obligations of the taxpayer alone, but the bank looked to the credit of taxpayer's sole stockholder in making the loans.

The Commissioner used $1,068.75, the fair market value of 300 shares of the Superpower company on the date of the transfer, as taxpayer's basis, and allocated to it $804.76 of the loss, on the ground that such allocation was necessary in order to properly reflect the taxpayer's income for that year. In this we think there was no error.

Congress has placed broad discretion in the Commissioner and the Board and we can not substitute our judgment for theirs unless that discretion has been abused. (*Heiner* v. *Diamond Alkali Co.*, 288 U. S., 502 [Ct. D. 652, C. B. XII–1, 333 (1933)].) The Revenue Act, of course, provides that cost is the proper basis for determining loss on securities sold. But the question of what is actual cost is to be determined by the Commissioner as a matter of fact, and he is given a wide latitude under section 45 of the Act in making such determination. The evidence here does not convince us that the Commissioner abused his discretion. We think he is supported in principle by *Asiatic Petroleum Co.* v. *Commissioner* (79 Fed. (2d), 234 [Ct. D. 1105, C. B. XV–1, 181 (1936)]). We approve the Board's decision, and it is affirmed.

SUBTITLE C.—SUPPLEMENTAL PROVISIONS.

SUPPLEMENT B.—COMPUTATION OF NET INCOME.

SECTION 113(a).—ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS: BASIS (UNADJUSTED) OF PROPERTY.

1941–16–10685
Ct. D. 1504

INCOME TAX—REVENUE ACTS OF 1928 AND 1932—DECISION OF SUPREME COURT.

1. GAIN OR LOSS—BASIS—SALE OF PERSONAL PROPERTY BY REMAINDERMEN UNDER TESTAMENTARY TRUST.

Remaindermen under a testamentary trust received distributions from the trustees in 1924, 1928, and 1931 of trust corpus consisting of securities some of which had been owned by the decedent at his death, others had been purchased by the executors, and some by the trustees. Sales of certain of the securities, including those received in exchange in a nontaxable transaction, were made by the remaindermen in 1930 and 1933. *Held:* For the reasons stated in *Maguire* v. *Commissioner* [Ct. D. 1506, page 366, this Bulletin], the basis for determining gain or loss upon such sales, under section 113 of the Revenue Acts of 1928 and 1932, is the value of the property when delivered by the executors to the trustees in the case of securities owned by the decedent at death and those purchased by the executors, and in the case of securities purchased by the trustees, the basis is cost to the trustees.

2. CAPITAL ASSET—HOLDING PERIOD IN CASE OF REMAINDERMEN UNDER TESTAMENTARY TRUST.

For the purpose of determining whether property constitutes a capital asset under the provisions of section 101(c)8 of the Revenue Act of 1928, the holding period in the case of securities purchased by trustees and distributed to a remainderman under a testamentary trust dates from the time of purchase by the trustees. *Helvering* v. *Gambrill* [Ct. D. 1505, page 364, this Bulletin] followed.

3. GAIN OR LOSS—BASIS—SALES OF STOCK—"FIRST-IN, FIRST-OUT" RULE—CONDITIONAL REMAINDER.

Where shares of stock were sold by remaindermen under a testamentary trust, some securities having been acquired under the trust and some having been later acquired in exchange for stock previously purchased by one of the remaindermen, and where the stock sold could not be identified with any particular shares so acquired, it must be presumed, under the "first-in, first-out" rule reflected in article 58 of Regulations 77, which adopts the rule of tacking contained in section 101(c)8(B) of the Revenue Act of 1932, that the stock received from the decedent's estate was the first sold, and the date of decedent's death is the date of acquisition for the purpose of determining gain or loss on such sales. The conditional nature of the remainder interest of one of the beneficiaries does not necessitate a different result. For the purpose of a point of reference and a standard of value for the determination of gain or loss realized on subsequent sales of property acquired by bequest, devise, or inheritance, distinctions between vested and contingent remainders or between absolute and conditional property interests have no relevancy.

4. DECISION REVERSED.

Decision of the United States Circuit Court of Appeals, Second Circuit (1940) (112 Fed. (2d), 530), affirming decision of the United States Board of Tax Appeals (1939) (39 B. T. A., 916), and two memorandum opinions of the Board (1939), reversed.

SUPREME COURT OF THE UNITED STATES.

Guy T. Helvering, Commissioner of Internal Revenue, petitioner, v. *Marjorie K. Campbell.*

Guy T. Helvering, Commissioner of Internal Revenue, petitioner, v. *Seymour H. Knox.*

Guy T. Helvering, Commissioner of Internal Revenue, petitioner, v. *Dorothy K. G. Rogers.*

[61 S. Ct., 798.]

On writs of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[March 31, 1941.]

OPINION.

Mr. Justice DOUGLAS delivered the opinion of the Court.

The questions presented by these cases are in part related to, and in part the same as those involved in *Maguire* v. *Commissioner*, No. 346 [Ct. D. 1506, page 366, this Bulletin], and *Helvering* v. *Gambrill*, No. 472 [Ct. D. 1505, page 364, this Bulletin], decided this day.

The father of these respondents died in 1915. By his will it was provided that his residuary estate should be divided into four parts. One part was devised and bequeathed to trustees: "To receive, hold and, from time to time, invest and reinvest the same, and to collect the rents, income, issues, and profits on the property from time to time constituting such trust fund and to pay over so much of the net income arising therefrom, as to my said trustees shall seem wise and proper toward the support, maintenance, and education of my daughter, Marjorie Knox, until she shall arrive at the age of twenty-one (21) years, and to accumulate the balance of the income during her minority for her benefit, and to pay over the accumulated income to her when she shall arrive at the age of twenty-one (21) years and thereafter to pay over the entire net income to my said daughter, Marjorie Knox, until she shall arrive at the age of twenty-eight (28) years, at which time, I give, devise, and bequeath to my said daughter, Marjorie Knox, one-half (½) of the property then constituting said trust fund and I direct my said trustees to pay over the net income on the remaining one-

half (½) of said trust fund until she shall arrive at the age of thirty-five (35) years, at which time I give, devise, and bequeath the remaining part of said trust fund to my said daughter, Marjorie Knox, and to her heirs and assigns forever. In the event that my said daughter, Marjorie Knox, shall die before reaching the age of thirty-five (35) years, I give, devise, and bequeath any part or portion of said trust fund, which has not then been paid over to her, or to the possession of which at the time of her death she was not entitled, unto the issue of said Marjorie Knox, if any, surviving her, to be divided among them, share and share alike. And in case there be no issue her surviving, then I give, devise, and bequeath said trust fund unto her heirs."

Marjorie Knox is respondent Marjorie K. Campbell. Another part of the residuary estate was placed in trust for respondent Dorothy K. G. Rogers, under the same terms. And a third part together with certain securities was placed in trust for respondent Seymour H. Knox, under similar terms. He, however, was to receive $500,000 of the trust fund when he reached the age of 25, one-half of the remaining trust fund when he became 30, and the balance at 35. Meanwhile, the income was payable to him. On July 1, 1921, the executors, pursuant to an order of the probate court, transferred the property to the trustees.

Marjorie K. Campbell attained the age of 28 on July 10, 1928, and received at that time one-half of the property of her trust. Certain of the securities which she then received were sold by her during 1933 and certain of the bonds matured and were paid during 1933. Some of those securities had been held by her father at his death, others had been purchased by the executors, and some had been purchased by the trustees. In 1926 and 1927 she purchased stock of the F. W. Woolworth Co., which with dividends received in 1927 amounted to 1,000 shares. In 1928 she received delivery from the trustees of 15,000 shares of Woolworth stock which represented shares owned by her father at his death, a subsequent tax-free stock split-up, stock dividends, and purchases by the trustees. In 1929 she surrendered the 16,000 shares she owned and received tax free 40,000 shares pursuant to a split-up of the stock. In 1933 she sold 10,000 of the shares received in 1929. There is no way of identifying the shares sold with any particular shares surrendered in 1929.

Dorothy K. G. Rogers became 28 on August 26, 1924, and 35 on August 26, 1931, at which times she received distributions of the corpus. During 1933 she sold securities so received. Some of those securities had been purchased by the trustees, some by the executors, and others had been owned by her father at his death.

Seymour H. Knox attained the age of 30 on September 1, 1928, and received on that date one-half of the corpus, including 8,575 shares of stock of Maine Share Corporation, of which 5,160 were purchased by the trustees on August 31, 1927, and 3,415 were purchased by the trustees on August 30, 1928. He later exchanged those shares in a nontaxable transaction and on June 10, 1930, sold the shares received in that exchange.

The Board of Tax Appeals[1] and the circuit court of appeals (112 Fed. (2d), 530) held: (1) that the basis to respondents under section 113(a)5 of the Revenue Acts of 1928 and 1932[2] as respects sales made by them was the fair market value at the time when the securities were delivered to them by the trustees, no matter when or how the trustees or the executors may have obtained the securities; (2) that in determining how long respondent Knox held securities for purposes of computing the term of his holding under section 101 of the Revenue Act of 1928, the date of transfer from the trustees should govern; and (3) that as respects the sale of Woolworth stock by respondent Campbell, her own shares should be treated, under the "first-in-first-out" rule, as sold prior to those which were delivered to her by the trustees.

It follows from our holding in *Maguire* v. *Commissioner*, supra, that the rulings on the first issue were erroneous. As respects the securities owned by the decedent at death, the basis is their value when delivered by the executors to the trustees. As respects the securities purchased by the trustees, the basis is cost to the trustees. And we are of the view that as respects securities purchased by the executors the basis is the value when delivered by them to the trustees. As we said in *Maguire* v. *Commissioner*, supra, the legislative history of section 113(a)5 clearly indicates that it applies to purchases by executors. Hence it follows from our reasoning in *Maguire* v. *Commissioner*, supra, that the date of delivery by the trustees to the beneficiaries is no more appropriate here than it is in case of property owned by the decedent at date of death.

[1] The opinion of the Board in *Helvering* v. *Campbell* is reported in 39 B. T. A., 916; its opinions in the other two cases are unreported.

[2] Section 113(a)5 of the 1932 Act (47 Stat., 169, 199) was the same as section 113(a)5 of the 1928 Act (45 Stat., 791, 819).

We also disagree with the court below on the second issue. Some of the securities were sold by respondent Knox more than two years after they had been purchased by the trustees.[3] For the reasons stated in *Helvering* v. *Gambrill*, supra, it follows, therefore, that they had been "held" by him for more than two years within the meaning of section 101(c)8.

We also take a different view on the third proposition. The "first-in-first-out" rule is reflected in Treasury regulations. The general rule[4] is that where shares of stock can not be identified with any particular lots purchased, they will be charged against the earliest purchases.[5] For the purpose of determining the earliest purchases the regulation[6] adopts the rule of tacking contained in section 101(c)8(B). That being true, it must be presumed that the Woolworth stock coming from the decedent's estate was first sold. The holding by the trustees is included in that of the beneficiary. Hence, as we indicated in *Helvering* v. *Gambrill*, supra, the date of acquisition by the beneficiary was the date of death. It is that date of acquisition which governs the application of the "first-in-first-out" rule. Therefore, the court below was in error in ruling that respondent Campbell's own shares were sold first.

Respondents have contended, at least in regard to some of these issues, that the nature of their remainder interests necessitates a different result. Thus, in case of respondent Knox it is strongly urged that in view of the conditional nature of his remainder interest he held the securities only from the date when his interest became indefeasible and the securities were distributed to him, since one can not be deemed to have held or acquired property which he might never obtain. But unlike the situation in *Helvering* v. *Hallock* (309 U. S., 106 [Ct. D. 1440, C. B. 1940–1, 223]), we are not concerned here with the question as to when the transfers took effect for purposes of the estate tax. As we indicated in *Maguire* v. *Commissioner*, supra, we are dealing only with a point of reference and a standard of value for determination of gains or losses realized on subsequent sales of property acquired by bequest, devise, or inheritance. For that purpose distinctions between vested and contingent remainders or between absolute and conditional property interests have no relevancy. Each remainderman has become the taxpayer because he has obtained possession and control of the property and has sold it. While the property is held in trust, the vested remainderman has no more rights of possession and control than the contingent remainderman. Yet each has acquired a property interest. The statutory provisions here in question come into play when that interest later ripens into full ownership and a sale is made. Hence the value of the property at the time when the taxpayer first acquires an interest in it has relevance to a subsequent determination of the gains or losses. As we remarked in *Maguire* v. *Commissioner*, supra, the residuary legatee in *Brewster* v. *Gage* (280 U. S., 327 [Ct. D. 148, C. B. IX–1, 274 (1930)]) was held to have acquired his interest at date of death though at that time it was not absolute. To be sure, in these cases the interest of the remaindermen in the property at the earlier time was limited by the very terms of the bequest. But the tax here in question is not on their remainder interests; it is on gains realized by them as owners of that property. Hence, to carry into that computation the earlier value of the property is not to tax them on values which they never received. It merely provides a rule of thumb in alleviation of a tax which would be computed by reference to the entire amount of the original inheritance were it to be based on cost to the taxpayer.

Reversed.

The CHIEF JUSTICE and Mr. Justice ROBERTS think the judgments should be affirmed for the reasons stated by the court below (112 Fed. (2d), 530).

[3] On this phase of the cases no question is presented as to securities purchased by executors.

[4] Article 58, Treasury Regulations 77, promulgated under the 1932 Act, provides:

"*Sale of stock and rights.*—When shares of stock in a corporation are sold from lots purchased at different dates or at different prices and the identity of the lots can not be determined, the stock sold shall be charged against the earliest purchases of such stock. In the determination of the earliest purchases of stock the rules prescribed in subparagraphs (A), (B), (C), and (D) of section 101(c)8 (relating to the period for which property has been held) shall be applied. * * *."

And see article 600(4) dealing with stock or securities distributed in reorganization.

[5] The regulations refer only to "purchases." But no question has been raised as to their application to shares acquired under a will. In fact, the Board of Tax Appeals stated (39 B. T. A., 916, 919) that the "parties are in agreement that the first in, first out rule must be applied, since the shares which the petitioner sold can not be identified as those purchased at any particular time." Furthermore, respondent concedes here that the rule should not be limited to securities which have been bought as distinguished from those which have been otherwise obtained.

[6] Article 58, supra note 4.

1941–16–10686
Ct. D. 1505

INCOME TAX—REVENUE ACT OF 1928—DECISION OF SUPREME COURT.

1. GAIN OR LOSS—BASIS—SALE OF PERSONAL PROPERTY BY REMAINDERMAN UNDER TESTAMENTARY TRUST.

For the reasons stated in *Maguire* v. *Commissioner* [Ct. D. 1506, page 366, this Bulletin], the basis under section 113 of the Revenue Act of 1928 for determining gain or loss upon the sale, by a remainderman under a testamentary trust, of trust property some of which was part of the original trust *res* and some was purchased by the trustees, is its value when distributed by the executors to the trustees if the property was owned by the decedent at the time of death, and cost to the trustees if it was purchased by them.

2. CAPITAL ASSET—HOLDING PERIOD IN CASE OF REMAINDERMAN UNDER TESTAMENTARY TRUST.

For the purpose of determining whether property constitutes a capital asset under the provisions of section 101(c)8 and 101(c)8(B) of the Revenue Act of 1928, the holding period in the case of personal property acquired by a remainderman under a testamentary trust dates from the decedent's death for property owned by decedent at the time of death, and from the date of purchase for property purchased by the trustees. *McFeely* v. *Commissioner* [Ct. D. 1040, C. B. XIV–2, 209 (1935)] (296 U. S., 102) followed.

3. DECISION REVERSED.

Decision of the United States Circuit Court of Appeals, Second Circuit (1940) (112 Fed. (2d), 530), affirming decision of the United States Board of Tax Appeals (1938) (38 B. T. A., 981), reversed.

SUPREME COURT OF THE UNITED STATES.

Guy T. Helvering, Commissioner of Internal Revenue, petitioner, v. *Richard Van Nest Gambrill.*

[61 S. Ct., 795.]

On writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[March 31, 1941.]

OPINION.

Mr. Justice DOUGLAS delivered the opinion of the Court.

The questions involved here are in part the same as those in *Maguire* v. *Commissioner*, No. 346 [Ct. D. 1506, page 366, this Bulletin], decided this day. Respondent was a remainderman under a trust created by the will of his grandmother[1] who died in 1897. The trust *res*, consisting of personalty, was delivered by the executors to themselves as trustees in 1898. The life beneficiary, respondent's mother, died in March, 1928. On May 5, 1928, the trustees delivered the corpus to respondent as remainderman. Some of the property was part of the original trust *res*, and some was purchased by the trustees both

[1] Respondent was the sole surviving issue of his mother, Anna Van Nest Gambrill, and took under the following provisions of his grandmother's will:

"Ninth. All the residue of my estate of every kind I give and devise as follows:

"'One half thereof in equal shares to my daughters Mary Van Nest Jackson, Anna Van Nest Gambrill, and Jennie Van Nest Foster, and my granddaughter, Mary Alice Van Nest absolutely.

"'The other half thereof in four equal shares to my executors, to hold the same in trust, one share for the benefit of each of the same four persons to wit my said three daughters and my said granddaughter and to receive the income and pay the same to her during her life with full power to invest and reinvest in their discretion without any limitation whatsoever and at her death to transfer and deliver the same as she if leaving issue shall by will direct or in the absence of such direction, to her issue equally, or if she shall leave no issue, then to the survivors of the said four persons to wit my said three daughters and my said granddaughter, and to the issue of any of the said four persons who may have died, the issue to take the share which the parent would have taken if living.'"

prior to and subsequent to March 1, 1913. During the year 1930 (in February, on May 6, and in June) respondent sold some of the property in each group. The Board of Tax Appeals (38 B. T. A., 981) and the circuit court of appeals (112 Fed. (2d), 530) held: (1) that for the purpose of determining gain or loss on the sale of the property in question the basis to respondent by virtue of section 113(a)5 of the Revenue Act of 1928 (45 Stat., 791) was the fair market value of the property on the date when the corpus was delivered to respondent; and (2) that the property sold in February, 1930, had not been held by the taxpayer for more than two years and was, therefore, not a capital asset within the meaning of section 101(c) of the 1928 Act, while that sold on May 6 and in June, 1930, had been held by respondent for more than two years and was therefore a capital asset.

The rulings on the first question were erroneous. For the reasons stated in *Maguire* v. *Commissioner*, supra, the basis under section 113(a)5 for the property delivered to respondent by the testamentary trustees was its value when distributed by the executors to the trustees if the property was owned by the decedent at her death, and cost to the trustees if it was purchased by them.[2]

We also disagree with the disposition made of the second question. Capital gains or losses are defined as those resulting from sales or exchanges of capital assets. (Section 101(c) (1) and (2).) Capital assets are defined (with exceptions not material here) as "property held by the taxpayer for more than two years." (Section 101(c)8.) And section 101(c)8(B) provides: "In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under the provisions of section 113, such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person."

We are of the view that under these provisions respondent's holding period dates from the decedent's death for property which she then owned and from the date of purchase for property purchased by the trustees. In *McFeely* v. *Commissioner* (296 U. S., 102 [Ct. D. 1040, C. B. XIV–2, 209 (1935)]), this Court held that a legatee's holding period under section 101(c)8 of the 1928 Act dated from the decedent's death for property owned by the decedent and distributed to the legatee by the executors, in spite of the fact that the legatee's basis under section 113(a)5 was value at the time of distribution to him by the executors. The date of acquisition was held to be the date of death, regardless of the gap between that date and the date of distribution. And that result was reached even though some of the taxpayers involved were residuary legatees whose interests at date of death were not unconditional. The reasoning of that case plus section 101(c)8(B) make it plain that respondent's interest, albeit a remainder, was acquired at the date of decedent's death for property then owned and at the date of purchase for property purchased by the trustees. The continuity in his holding was not broken by the intervening trust. The formal constitution of that trust though of special significance under section 113(a)5 (*Maguire* v. *Commissioner*, supra) did not change the basic quality of his property interest. And the fact that that interest did not ripen into full and complete ownership except by the passage of time or the occurrence of subsequent events is inconsequential. For section 101(c)8(B) provides, as we have seen, that in determining the taxpayer's holding period there shall be included the period for which the property was held by any other person if under section 113 the property had the same basis in whole or in part in the taxpayer's hands as it would have in the hands of the other person. It is plain that under section 113 the basis to the trustees was the same as the basis to the taxpayer. Hence the period of their holding is not to be excluded from the period of the taxpayer's holding. That makes plain that "property held by the taxpayer" as used in section 101(c)8 embraces not only full ownership but also any interest whether vested, contingent, or conditional. Otherwise the period of the holding by trustees

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[2] It should, of course, be noted that section 113(b) provided:

"(b) PROPERTY ACQUIRED BEFORE MARCH 1, 1913.—The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be:

"(1) the cost of such property (or, in the case of such property as is described in subsection (a) (1), (4), (5), or (12) of this section, the basis as therein provided), or

"(2) the fair market value of such property as of March 1, 1913, whichever is greater. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date."

would not be included in the holding by a mere remainderman. Hence, as in *McFeely* v. *Commissioner*, supra, we look to the time when the taxpayer first acquired the interest which later ripened into full ownership. It is plain that for property owned by the decedent he acquired that interest at her death and that for property purchased by the trustees he acquired that interest at the date of purchase.

Reversed.

The CHIEF JUSTICE and Mr. Justice ROBERTS think the judgment should be affirmed for the reason stated by the court below (112 Fed. (2d), 530).

1941–16–10687
Ct. D. 1506

INCOME TAX—REVENUE ACT OF 1928—DECISION OF SUPREME COURT.

1. GAIN OR LOSS—BASIS—SALES OF PERSONAL PROPERTY RECEIVED BY BENEFICIARY UNDER TESTAMENTARY TRUST.

The beneficiary of a trust, established pursuant to the will of her father, received in 1923 from the trustees personal property part of which had been owned by the decedent and part purchased by the trustees. During the year 1930 parts of both groups of property were sold. In determining gain or loss upon such sales, under the provisions of section 113 of the Revenue Act of 1928, the basis in the case of property which had been owned by the decedent is, under section 113(a)5 of that Act, its value at the date when it was received by the trustees from the executors and not its value at the date of delivery by the trustees to the beneficiary. "Distribution to the taxpayer" as used in that subsection is not necessarily restricted to situations where property is delivered to the taxpayer, but includes the case where property is delivered by the executors to trustees in trust for the taxpayer. In the case of property which had been purchased by the trustees, the basis is its cost to the trustees and not its value at the date of delivery by the trustees to the beneficiary. In the latter case the property was not "acquired * * * by will" within the meaning of section 113(a)5, and the basis is cost, as provided in section 113(a).

2. DECISION AFFIRMED.

Decision of the United States Circuit Court of Appeals, Seventh Circuit (1940) (111 Fed. (2d), 843), reversing memorandum opinion of the United States Board of Tax Appeals (1939), affirmed.

SUPREME COURT OF THE UNITED STATES.

Jeremiah D. Maguire and Ruth S. Maguire, petitioners, v. *Commissioner of Internal Revenue.*

[61 S. Ct., 789.]

On writ of certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.

[March 31, 1941.]

OPINION.

Mr. Justice DOUGLAS delivered the opinion of the Court.

The taxpayer's[1] share of a testamentary trust, established pursuant to the will of her father, was delivered to her in kind in 1923. The property was personalty, part of which had been owned by the decedent and part purchased by the trustees. The decedent died in 1903 and his executors were discharged by the probate court in 1905. Pursuant to that order the executors turned over

[1] Petitioners are husband and wife who filed a joint return. The income here involved is that of the wife.

to themselves, as trustees, all of the residue of the estate.[2] From that residue the taxpayer's claim to the property in question derived. During the year 1930 parts of both groups of property were sold.[3] The questions presented relate to the proper basis under the Revenue Act of 1928 (45 Stat., 791) for determining gain or loss upon those sales: (1) whether the basis in case of the personalty owned by decedent is its value when received by the trustees from the executors or its value at the date of delivery by the trustees to the taxpayer; and (2) whether the basis in case of the personalty purchased by the trustees is its cost to the trustees or its value at the date of delivery by the trustees to the taxpayer. The case is here on a petition for certiorari which we granted because of a conflict among the circuits on those two questions.[4]

I. As respects the property owned by the decedent at his death, we are of the view that the date when it was received by the trustees from the executors, rather than the date when it was delivered by the trustees to the taxpayer, governs. In the case of general bequests, section 113(a)5 of the Revenue Act of 1928 provided that "the basis shall be the fair market value of the property at the time of the distribution to the taxpayer."[5] But in case of specific bequests of personalty or in case of realty, the basis was the fair market value of the property at the death of the decedent. (Section 113(a)5.) In the latter cases the property either vested in the heir or devisee at death or was rather definitely marked at the time of death for the legatee. In the former the legatee normally must have awaited administration of the estate before the property bequeathed to him could have been identified with certainty. That difference suggests the distinction in treatment under section 113(a)5 of general bequests of personalty. It emphasizes that the words "at the time of the distribution to the taxpayer" meant the time when the distribution was made out of the estate. It supports the view that Congress focused section 113(a)5 on the decedent's death and the administration of his estate, and not on subsequent transfers or transmissions of the property.

The legislative history of section 113(a)5 lends support to that conclusion. Prior to the 1928 Act the basis for property obtained by bequest, devise, or inheritance was the fair market value "at the time of such acquisition."[6] The House bill[7] which became the Revenue Act of 1928 provided that the basis for

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[2] The will directed the executors and trustees, not less than 10 and not more than 20 years after the death of the testator, to make final distribution of this residue as follows: "* * * to my wife the one-third part thereof, the balance to be equally divided among my children, share and share alike, and should my wife not be living at the time of such distribution, then the same shall be divided equally among my children, share and share alike, the descendants of any deceased children in such distribution to take the proportion of their deceased parent, * * *."

[3] The sales were made by trustees of new *inter vivos* trusts under which the property had been placed on its delivery in 1923. It was stipulated that the beneficiaries (including the taxpayer) were taxable as though the sales were made by them individually.

[4] The opinion of the court below is reported at 111 Fed. (2d), 843. On the first question it held that the basis was the value at the time the property was received by the trustees from the executors; on the second, that the basis was cost to the trustees. On those two questions that decision is in conflict with *Commissioner* v. *Gambrill* (112 Fed. (2d), 530), from the Second Circuit Court of Appeals. And see *Commissioner* v. *Libbey* (100 Fed. (2d), 458).

[5] Section 113(a)5 provided: "(a) PROPERTY ACQUIRED AFTER FEBRUARY 28, 1913.—The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that * * * (5) PROPERTY TRANSMITTED AT DEATH.—If personal property was acquired by specific bequest, or if real property was acquired by general or specific devise or by intestacy, the basis shall be the fair market value of the property at the time of the death of the decedent. If the property was acquired by the decedent's estate from the decedent, the basis in the hands of the estate shall be the fair market value of the property at the time of the death of the decedent. In all other cases if the property was acquired either by will or by intestacy, the basis shall be the fair market value of the property at the time of the distribution to the taxpayer In the case of property transferred in trust to pay the income for life to or upon the order or direction of the grantor, with the right reserved to the grantor at all times prior to his death to revoke the trust, the basis of such property in the hands of the persons entitled under the terms of the trust instrument to the property after the grantor's death shall, after such death, be the same as if the trust instrument had been a will executed on the day of the grantor's death;"

Section 113(b) provided: "(b) PROPERTY ACQUIRED BEFORE MARCH 1, 1913.—The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be: (1) the cost of such property (or, in the case of such property as is described in subsection (a) * * * (5) * * * of this section, the basis as therein provided), or (2) the fair market value of such property as of March 1, 1913, whichever is greater."

[6] Revenue Act of 1921 (42 Stat., 227), section 202(a); Revenue Act of 1924 (43 Stat., 253), section 204(a); Revenue Act of 1926 (44 Stat., 9), section 204(a).

[7] H. R. 1, Seventieth Congress, first session.

all property acquired by bequest, devise, or inheritance should be the fair market value of the property at the date of the decedent's death—a provision designed to clarify [8] the meaning of "acquisition" in the earlier Acts.[9] In the Senate that language of section 113(a)5 was changed to the form in which it appeared in the Revenue Act of 1928—a change specifically designed to avoid the confusion as to the basis on which gain or loss on the sale of property purchased by the executor and distributed to beneficiaries was to be determined.[10]

There does not appear to be the slightest suggestion that this change was designed as a substantial departure from the value-at-death rule. To be sure, it did produce a limited deviation from that principle in that no income tax effect was to be given changes in value of personal property, passing otherwise than by specific bequest, during the administration of the estate. But to hold that it effected the change which petitioner urges would be to impute to Congress a purpose to go far beyond the exigencies of the specific situations with which it was dealing.

The language used does not require that result. "Distribution to the taxpayer" is not necessarily restricted to situations where property is delivered to the taxpayer. It also aptly describes the case where property is delivered by the executors to trustees in trust for the taxpayer. Such distribution of the estate results in the acquisition by the taxpayer of an equitable estate under the testamentary trust. The fact that he does not then obtain possession or control, the fact that his interest is conditional or contingent, the fact that legal title may not be transferred to him until years later, are immaterial. Section 113(a)5 merely provided a point of reference and a standard of value for determination of gains or losses realized on subsequent sales of property acquired by bequest, devise, or inheritance. In *Brewster* v. *Gage* (280 U. S., 327, 334), this Court held under earlier Acts [11] that the date of death was the date of "acquisition" even in case of a residuary legatee whose interest at the date of death clearly was not absolute. That conclusion suggests that the critical date is the time when the legatee acquires some interest in the property although his interest then may not be unconditional. Hence, in case of remainders governed by section 113(a)5 of the 1928 Act, it can not realistically be asserted that the date when the remainderman acquired his interest came later than the time when he obtained an equitable estate under the testamentary trust.

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[8] H. Rept. No. 2, Seventieth Congress, first session (Int. Rev. C. B. 1939–1 (Part 2), 396). And see report of the Joint Committee on Internal Revenue Taxation (H. Doc. No. 139, Seventieth Congress, first session), pages 17–18.

[9] Much of that confusion was later eliminated by *Brewster* v. *Gage* (280 U. S., 327 [Ct. D. 148, C. B. IX–1, 274 (1930)]), holding that in case of a residuary legatee of personal property the time of "acquisition" was the date of decedent's death, not the date of distribution of the property by the executors to the legatee. That decision was rendered in 1930 under the 1918 and 1921 Acts. The wording of section 113(a)5 contained in the 1928 Act was continued in the 1932 Act (47 Stat., 169, 199). But under the 1934 Act (48 Stat., 680, 706) there was a return to the language of the 1926 Act, the Senate report stating: "Section 113(a)5 of the Revenue Act of 1932 is a reenactment of a similar provision contained in the 1928 Act. The change in the 1928 Act was made because there was some doubt as to the meaning of the term 'date of acquisition,' which was the term used under the Revenue Act of 1926. Since the 1928 Act was passed, the Supreme Court has defined 'the date of acquisition' to mean the date of death in the case of all property passing by bequest, devise, and inheritance, whether real or personal. (*Brewster* v. *Gage*, 280 U. S., 327.) Section 113(a)5 of the House bill conforms to the language contained in the Revenue Act of 1926, so that a uniform basis rule may be required in the case of property passing at death, whether real or personal." (S. Rept. No. 558, Seventy-third Congress, second session, Int. Rev. C. B., supra note 8, pages 612–613.)

[10] S. Rept. No. 960, Seventieth Congress, first session (Int. Rev. C. B., supra note 8, page 409), where it was said (page 427): "It appears that the House bill is inadequate to take care of a number of situations which frequently arise. For example, the executor, pursuant to the terms of the will, may purchase property and distribute it to the beneficiaries, in which case it is impossible to use the value at the decedent's death as the basis for determining subsequent gain or loss, for the decedent never owned the property. Moreover, the fair market value of the property at the decedent's death can not properly be used as the basis, in the case of property transferred in contemplation of death where the donee sells the property while the donor is living.

"Accordingly, the committee has revised section 113(a)5 and certain related sections, so as to provide that in the case of a specific bequest of personalty or a general or specific devise of realty, or the transmission of realty by intestacy, the basis shall be the fair market value at the time of the death of the decedent. In these cases it may be said, as a matter of substance, that the property for all practical purposes vests in the beneficiary immediately upon the decedent's death, and therefore the value at the date of death is a proper basis for the determination of gain or loss to the beneficiary. The same rule is applied to real and personal property transmitted by the decedent, where the sale is made by the executor. In all other cases the basis is the fair market value of the property at the time of the distribution to the taxpayer. The latter rule would obtain, for example, in the case of personal property not transmitted to the beneficiary by specific bequest, but by general bequest or by intestacy. It would also apply in cases where the executor purchases property and distributes it to the beneficiary."

[11] See note 9, supra.

There are other reasons why we can not infer that Congress intended to make more than a limited departure from the value-at-death principle in enacting section 113(a)5 of the 1928 Act. As respondent points out, there would be a substantial disparity between the treatment of remaindermen of realty and remaindermen of personalty under the same testamentary trust, if the latter were given a basis of value at the time of distribution by the trust. Furthermore, we can not on the basis of the legislative history of section 113(a)5 impute to Congress a purpose to allow trustees either to sell the property or to distribute it in kind, as would be most advantageous for tax purposes. The creation of such an opportunity for manipulation of tax liability can not be lightly presumed. Similarly we can not assume in absence of explicit provisions that Congress intended to create substantial periods of time following the date of death during which the value of the property bequeathed would have no incidence as respects subsequent gains or losses. Respect for the obvious symmetry of this statutory scheme induces the conclusion that there was a "distribution to the taxpayer" when this property was delivered by the executors to the trustees.[12]

II. As respects the property which was purchased by the trustees, we are of the view that its cost to them, rather than its value at the date of delivery to the taxpayer, governs. Section 113(a) provided that the basis in case of property acquired after February 28, 1913, should be "the cost of such property."[13] That standard controls here unless these transactions are governed by the provision of section 113(a)5 that, "In all other cases if the property was acquired either by will or by intestacy, the basis shall be the fair market value of the property at the time of the distribution to the taxpayer." The latter provision is applicable if the property in question was "acquired * * * by will." We think it was not.

The title of section 113(a)5 is "Property transmitted at death." While the title of an Act will not limit the plain meaning of the text (*Caminetti* v. *United States*, 242 U. S., 470, 490; *Strathearn S. S. Co.* v. *Dillon*, 252 U. S., 348, 354), it may be of aid in resolving an ambiguity. (*Knowlton* v. *Moore*, 178 U. S., 41, 65.) It suggests, as does the legislative history which we have related, that the foregoing provision of section 113(a)5 was confined, with minor exceptions, to the specific property owned by the decedent at his death. To be sure, the taxpayer's right in the property in question had its source in the provisions of the will. But there is no indication that Congress in drafting section 113(a)5 looked beyond the distribution of the estate by the executors. In that connection, the Senate report specifically stated that the foregoing provision of section 113(a)5 governed purchases by the executors.[14] No reference was made to purchases by testamentary trustees. The inference is strong that Congress was fashioning section 113(a)5 on the theory that for income tax purposes acquisition of personal property passing by general bequest or intestacy did not occur until distribution of the estate was made. In that posture of the problem, property purchased by the executor (acting, so to speak, in the decedent's stead) prior to that distribution was acquired by the distributee "by will." But once the administration of the estate had been completed and the basic testamentary disposition effected, subsequent purchases were to be governed by cost as provided in section 113(a). Property so purchased would not be part of the original inheritance. Certainly if the trustees themselves had sold the property, the transaction would have been taxable on the cost basis. To hold that a different basis applies in case the beneficiary made the sale would be to open an avenue for tax avoidance. Furthermore, we are dealing here with a statutory scheme which in general recognizes value at the date of death in computing subsequent gains or losses. We are not inclined in absence of clear and unambiguous language to imply a greater deviation from that principle than that which is necessitated by the declared objective of Congress.

Affirmed.

The CHIEF JUSTICE and Mr. Justice ROBERTS are of opinion that the judgment should be reversed for the reasons stated in the opinion of the Circuit Court of Appeals for the Second Circuit in *Commissioner* v. *Gambrill* (112 Fed. (2d), 530).

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[12] We are not aided by administrative construction. The Bureau of Internal Revenue originally took the view which we have reached (G. C. M. 6195, C. B. VIII–1, 99 (1929)). This view was reversed in G. C. M. 11309 (C. B. XII–1, 126 (1933)). Its original view was again taken in G. C. M. 14893 (C. B. XIV–1, 202 (1935)).

[13] See note 5, supra. And see section 113(b), supra note 5, as respects the basis in case of property acquired before March 1, 1913.

[14] S. Rept. No. 960, supra note 10.

1941–23–10735
Ct. D. 1515

INCOME TAX—REVENUE ACTS OF 1934 AND 1936—DECISION OF SUPREME COURT.

1. GAIN OR LOSS—BASIS—SALE OF SECURITIES RECEIVED BY LEGATEES UNDER TESTAMENTARY TRUST.

For the reasons stated in *Helvering* v. *Reynolds* [Ct. D. 1516, page 371, this Bulletin], the basis under section 113(a)5 of the Revenue Acts of 1934 and 1936 for determining gain or loss upon sales in 1934 and 1936, by legatees under a testamentary trust, of securities owned by the decedent and distributed to the legatees by the testamentary trustee in 1923, is the value of such securities on the date of death of the decedent. The fact that the interests of the legatees on the date of decedent's death may have been contingent is immaterial.

2. DECISIONS AFFIRMED.

Decisions of the United States Circuit Court of Appeals, Second Circuit (1941) (116 Fed. (2d), 800) affirming memorandum opinions of the United States Board of Tax Appeals (1940), affirmed.

SUPREME COURT OF THE UNITED STATES.

Mary Flagler Cary, petitioner, v. *Commissioner of Internal Revenue.*

Harry Harkness Flagler, petitioner, v. *Commissioner of Internal Revenue.*

Estate of Annie L. Flagler, Deceased, Harry Harkness Flagler, Executor, petitioner, v. *Commissioner of Internal Revenue.*

Jean Louise Matthews, petitioner, v. *Commissioner of Internal Revenue.*

[61 S. Ct., 978.]

On writs of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[May 26, 1941.]

OPINION.

Mr. Justice DOUGLAS delivered the opinion of the Court.

Henry M. Flagler died on May 20, 1913. Petitioners are legatees under a testamentary trust created under his will. The trust continued for a period of 10 years from his death and terminated on May 20, 1923. As of that time the trustees delivered to petitioners[1] certain securities which were sold by them in 1934 and 1936. The question presented is whether the basis for computing gain or loss on such sales under section 113(a)5 of the Revenue Acts of 1934 (48 Stat., 680) and 1936[2] (49 Stat., 1648) is the value of the securities when delivered to the legatees or their value on the date of death of the decedent. Petitioners make substantially the same argument for application of the former criterion as did respondent in *Helvering* v. *Reynolds*, No. 684, decided this day [Ct. D. 1516, page 371, this Bulletin]. And they contend that under Florida law they had at the date of death only contingent interests. But assuming they are correct in the latter contention, it is of no avail. For the reasons stated in *Helvering* v. *Reynolds*, supra, the proper basis was the value of the securities at the death of the decedent. Accordingly, the judgments of the court below (116 Fed. (2d), 800) must be

Affirmed.

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[1] Some securities had previously been delivered to Harry Harkness Flagler, petitioner in No. 735, on April 26, 1921. Annie L. Flagler, whose estate is the petitioner in No. 736, received the securities here involved as a gift from her husband, Harry Harkness Flagler. The situation therefore is the same as to both these parties, since it is stipulated that he had received the securities as indicated above.

[2] Section 113(a)5 of the 1936 Act is the same as section 113(a)5 of the 1934 Act. Article 113(a)(5)–1 of Treasury Regulations 94, promulgated under the 1936 Act, contains provisions identical with those of article 113(a)(5)–1 of Regulations 86 under the 1934 Act. The relevant portions of that section and regulation under the 1934 Act are set forth in *Helvering* v. *Reynolds*, supra.

1941-23-10736
Ct. D. 1516

INCOME TAX—REVENUE ACT OF 1934—DECISION OF SUPREME COURT.

1. GAIN OR LOSS—BASIS—SALES OF SECURITIES RECEIVED BY CONTINGENT REMAINDERMAN UNDER TESTAMENTARY TRUST.

The remainderman of a trust, established by the will of his father, received in 1934 from the trustee securities part of which had been owned by the decedent and part purchased by the trustee. During the year 1934 some of the securities in each group were sold. In determining gain or loss upon such sales under the provisions of section 113 of the Revenue Act of 1934, the basis in the case of securities which had been owned by the decedent is, under section 113(a)5 of that Act, their value at the time of decedent's death even though the remainderman's interest was then contingent. "Acquisition" as used in that subsection embraces all interests which have their origin in a bequest, devise, or inheritance. In the case of securities purchased by the trustee, the proper basis is their cost to him for the reasons stated in *Maguire* v. *Commissioner* [Ct. D. 1506, page 366, this Bulletin] (312 U. S., —). In the latter case the securities were not "acquired by bequest, devise, or inheritance" within the meaning of section 113(a)5 and their basis is cost, as provided in section 113(a).

2. REGULATIONS SUSTAINED.

The provisions of article 113(a)(5)-1(*b*) of Regulations 86, promulgated on February 11, 1935, under the Revenue Act of 1934, are valid. The fact that the regulations were not promulgated until after the transactions in question had been consummated and that administrative construction of the term "acquisition" under earlier Acts, as applied to a contingent interest, had been different are not material. *Helvering* v. *R. J. Reynolds Tobacco Co.* (306 U. S., 110 (Ct. D. 1383, C. B. 1939-1 (Part 1), 225)) distinguished.

3. DECISION REVERSED.

Decision of the United States Circuit Court of Appeals, Fourth Circuit (1940) (114 Fed. (2d), 804), reversing decision of the United States Board of Tax Appeals (1940) (41 B. T. A., 59), reversed.

SUPREME COURT OF THE UNITED STATES.

Guy T. Helvering, Commissioner of Internal Revenue, petitioner, v. *Richard J. Reynolds.*

[61 S. Ct., 971.]

On writ of certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

[May 26, 1941.]

OPINION.*

Mr. Justice DOUGLAS delivered the opinion of the Court.

Respondent's father died in 1918, leaving him a remainder interest in a testamentary trust, an interest which the court below found to be contingent under North Carolina law. He received his share of the trust, including securities, from the trustee on April 4, 1934. Some of the securities so distributed had been received by the trustee from the decedent's estate and others had been purchased by the trustee between 1918 and 1934. During the year 1934 respondent sold some of the securities in each group. In computing his gains and losses he used as the basis the value on April 4, 1934, when he received the securities from the trustee. The Commissioner determined that the proper basis under the Revenue Act of 1934 (48 Stat., 680) was the value of the securities at the time of decedent's death in the case of those then held by decedent and their cost to the trustee in the case of those which the trustee had purchased. The Board of Tax Appeals sustained the Commissioner. (41 B. T. A., 59.) The circuit court of appeals reversed. (114 Fed. (2d), 804.) We granted the

petition for certiorari (exclusive of the question whether the remainder was vested or contingent under the law of North Carolina) because of a conflict among the circuits.[1]

Section 113(a)5 of the 1934 Act provided: "If the property was acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, the basis shall be the fair market value of such property at the time of such acquisition." The Government places considerable stress on *Maguire* v. *Commissioner* (312 U. S., — [Ct. D. 1506, page 366, this Bulletin]); *Helvering* v. *Gambrill* (312 U. S., — [Ct. D. 1505, page 364, this Bulletin]); and *Helvering* v. *Campbell* (312 U. S., — [Ct. D. 1504 page 360, this Bulletin]), decided under the 1928 and 1932 Acts, in support of its contention that as respects securities owned by decedent the proper basis was their value at his death even though respondent's interest was then contingent. And it also relies on Treasury Regulations 86, promulgated under the 1934 Act, article 113(a)(5)–1(*b*) of which provided that "all titles to property acquired by bequest, devise, or inheritance relate back to the death of the decedent, even though the interest of him who takes the title was, at the date of death of the decedent, legal, equitable, vested, contingent, general, specific, residual, conditional, executory, or otherwise." Respondent on the other hand urges that the phrase "at the time of such acquisition" when it was included in the 1934 Act had acquired by construction a definite meaning which excluded contingent remainders and therefore that Congress must be presumed to have used those words in that sense. In that connection he points out that the phrase "at the time of such acquisition" had appeared in the 1921, 1924, and 1926 Acts[2] and that certain office decisions of the Treasury[3] and certain decisions of the lower Federal courts[4] under those Acts, made prior to the enactment of the 1934 Act, had held that a beneficiary did not acquire property when his interest was merely contingent. Respondent emphasizes that the legislative history of the 1934 Act shows no mention of the prior administrative and judicial treatment of contingent remainders and makes no complaint with the practice of the Bureau or with the decisions. He insists that the words "acquired" or "acquisition" are not vague or ambiguous words but mean to obtain "as one's own," as held in *Helvering* v. *San Joaquin Fruit & Investment Co.* (297 U. S., 496, 499). By these arguments and related ones respondent seeks to demonstrate that the earlier rule had become embedded in the law so that it could be changed not by administrative rules or regulations but by Congress alone. On the basis of such reasoning and the difference in wording between the 1934 Act and the 1928 and 1932 Acts, he seeks to distinguish the Maguire, Gambrill, and Campbell cases. And since article 113(a)(5)–1(*b*) was promulgated on February 11, 1935, respondent insists that to make it applicable to transactions occurring in 1934 would be to give it a retroactive effect contrary to *Helvering* v. *R. J. Reynolds Tobacco Co.* (306 U. S., 110 [Ct. D. 1383, C. B. 1939–1 (Part 1), 225]).

Respondent's position is not tenable. We are not dealing here with a situation where the meaning of statutory language is resolved by reference to explicit statements of Congressional purpose. (*Maguire* v. *Commissioner*, supra; *Helvering* v. *Campbell*, supra.) Here the committee reports[5] on the 1934 Act are wholly silent as to whether a taxpayer has acquired property within the meaning of section 113(a)5 at a time when he has obtained only a contingent remainder interest. And we need not stop to inquire whether, in absence of the Treasury regulations under the 1934 Act, the administrative construction of "acquisition" under the earlier Acts was of such a character (*Higgins* v. *Commissioner*, 312 U. S., 212) and the prior judicial decisions had such consistency and uniformity that Congressional reenactment of the language in question was an adoption of its previous interpretation within the rule of such cases as *United States* v. *Dakota-Montana Oil Co.* (288 U. S., 459 [Ct. D. 655, C. B. XII–1, 243 (1933)]). That rule is no more than an aid in statutory construc-

[1] Opposed to the decision below are *Van Vranken* v. *Helvering* (115 Fed. (2d), 709); *Cary* v. *Helvering* (116 Fed. (2d), 800); *Archbold* v. *Helvering* (115 Fed. (2d), 1005)—all from the Second Circuit; and *Augustus* v. *Commissioner* (118 Fed. (2d), 38), from the Sixth Circuit.

[2] Section 202(a)3, Revenue Act of 1921 (42 Stat., 229); section 204(a)5, Revenue Act of 1924 (43 Stat., 258); section 204(a)5, Revenue Act of 1926 (44 Stat., 14).

[3] O. D. 727 (C. B. 3, 53 (1920)); G. C. M. 10260 (C. B. XI–1, 79, 80 (1932)).

[4] See, for example, *Pringle* v. *Commissioner* (64 Fed. (2d), 863); *Hopkins* v. *Commissioner* (69 Fed. (2d), 11). Cf. *Lane* v. *Corwin* (63 Fed. (2d), 767).

[5] H. Rept. No. 704, Seventy-third Congress, second session, pages 27–28 [C. B. 1939–1 (Part 2), 554]; S. Rept. No. 558, Seventy-third Congress, second session, pages 34–35 [C. B. 1939–1 (Part 2), 586].

tion. While it is useful at times in resolving statutory ambiguities, it does not mean that the prior construction has become so embedded in the law that only Congress can effect a change. (*Morrissey* v. *Commissioner*, 296 U. S., 344, 355 [Ct. D. 1064, C. B. XV–1, 264 (1936)].) And see *Murphy Oil Co.* v. *Burnet* (287 U. S., 299 [Ct. D. 619, C. B. XII–1, 231 (1933)].) It gives way before changes in the prior rule or practice through exercise by the administrative agency of its continuing rule-making power. (*Helvering* v. *Wilshire Oil Co.*, 308 U. S., 90, 100–101 [Ct. D. 1424, C. B. 1939–2, 213].) Nor is article 113(a)(5)–1(*b*) of the regulations condemned by *Helvering* v. *R. J. Reynolds Tobacco Co.*, supra. That case turned on its own special facts. The transactions there in question took place at a time when a regulation was in force which expressly negatived any tax liability. The regulation remained outstanding for a long time and was followed by several reenactments of the statute. About five years after the transactions in question took place the prior regulation was amended so as to impose a tax liability There are no such circumstances here. No relevant regulation was in force at the time respondent sold the securities in 1934. The regulation here in question was promulgated under the very Act which determines respondent's liability. The fact that the regulation was not promulgated until after the tranactions in question had been consummated is immaterial. (Cf. *Manhattan General Equipment Co.* v. *Commissioner*, 297 U. S., 129.) The magnitude of the task of preparing regulations under a new Act may well occasion some delay. To hold that respondent had a vested interest in a hypothetical decision in his favor prior to the advent of the regulations would introduce into the scheme of the Revenue Acts refined notions of statutory construction which would, to say the least, impair an important administrative responsibility in the tax collecting process.

Hence the regulation governs this case if the word "acquisition" as used in section 113(a)5 was susceptible of this administrative interpretation. We think it was. However unambiguous that word might be as respects other transactions (*Helvering* v. *San Joaquin Fruit & Investment Co.*, supra) its meaning in this statutory setting was far from clear as respects property passing by bequest, devise, or inheritance. The definition of "acquisition" contained in the regulation is not a strained or artificial one. Admittedly the date of death would be the proper basis if respondent's interest under the testamentary trust had been a vested remainder. But even a vested remainderman does not have all of the attributes of ownership. So the test in this type of case is not whether respondent had full enjoyment of the property prior to the delivery of the securities to him but whether he earlier had acquired an interest which ultimately ripened into complete ownership. Respondent has become the taxpayer because he has obtained full ownership of the property and has sold it. The tax is on gains, if any, realized by him in that transaction. Hence, as we indicated in the Maguire and Campbell cases, to carry into that computation the value of the property at the time the taxpayer had only a contingent remainder interest in it is not to tax him on values which he never received. The statute as thus interpreted "merely provides a rule of thumb in alleviation of a tax which would be computed by reference to the entire amount of the original inheritance were it to be based on cost to the taxpayer." (*Helvering* v. *Campbell*, supra.) As stated by Judge Arant in *Augustus* v. *Commissioner* (118 Fed. (2d), 38, 43), the regulation was an "apt interpretation to make this part of the statute fit efficiently and consistently into the scheme of the revenue system as a whole." See *Maguire* v, *Commissioner*, supra.

Respondent's suggestion that the regulation does not cover this case will not stand analysis. It has a broad sweep and embraces all interests which have their origin in a bequest, devise, or inheritance.

For the reasons stated, the proper basis as to the securities owned by the decedent was their value at his death.

There remains the question as to the proper basis for securities purchased by the trustee. In the Maguire case we held that "cost" was the proper basis as provided in section 113(a) of the 1928 Act since securities purchased by a trustee were not "acquired * * * by will" within the meaning of section 113(a)5 of that Act. While section 113(a)5 of the 1934 Act substitutes "acquired by bequest, devise, or inheritance" for "acquired either by will or intestacy" in the 1928 Act, that change does not call for a result different from that reached in the Maguire case. For the reasons there stated, we hold that as respects securities purchased by the trustee the proper basis is the cost to him. That makes it unnecessary to examine the validity of the holding of the

court below that article 113(a) (5)-1(*d*) of the regulations[6] is inapplicable because decedent did not die before March 1, 1913.

Reversed.

SECTION 116.—EXCLUSIONS FROM GROSS INCOME.

REVENUE ACTS OF 1928, 1932, AND 1934.

Meaning of term "coastwise," as used in G. C. M. 22383 (C. B. 1940-2, 227). (See I. T. 3461, page 251.)

REVENUE ACTS OF 1928, 1932, AND 1934.

Wages of seamen employed on vessels engaged in coastwise trade. (See I. T. 3467, page 252.)

SECTION 117.—CAPITAL GAINS AND LOSSES.

ARTICLE 117-2: Limitations on capital gains and capital losses. 1941-2-10560 G. C. M. 22491

REVENUE ACT OF 1932.

In applying the limitation on stock losses prescribed by section 23(r) of the Revenue Act of 1932, a taxpayer may offset his personal losses from the sale of securities held for a period of two years or less against his share of similar gains of a partnership.

G. C. M. 14012 (C. B. XIV-1, 145 (1935)) revoked. Recommended that I. T. 2892 (C. B. XIV-1, 148 (1935)) be modified.

Reconsideration has been given to G. C. M. 14012 (C. B. XIV-1, 145 (1935)) in the light of the decision of the United States Supreme Court in *Neuberger* v. *Commissioner* (61 S. Ct., 97, Ct. D. 1470, C. B. 1940-2, 228).

In G. C. M. 14012, supra, it was held that in applying the limitation on stock losses prescribed by section 23(r) of the Revenue Act of 1932, a taxpayer may not offset his personal losses from the sale of securities held for a period of two years or less against his share of similar gains of a partnership.

In *Neuberger* v. *Commissioner*, supra, it was held, in effect, that an individual engaged in trading in securities is entitled, under section 23(r) of the Revenue Act of 1932, to offset losses from the sale for his own account of securities which are not capital assets against his share of gains from the sale of similar noncapital assets by a partnership of which he is a member. In view of the decision of the Supreme Court in that case, G. C. M. 14012, supra, is revoked.

It is recommended that I. T. 2892 (C. B. XIV-1, 148 (1935)) be modified to the extent that it is inconsistent with the decision in the Neuberger case.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

[6] *Property acquired before March 1, 1913; reinvestments by fiduciary.*—If the decedent died before March 1, 1913, the fair market value on that date is taken in lieu of the fair market value on the date of death, but only to the same extent and for the same purposes as the fair market value on March 1, 1913, is taken under section 113(a)(14).

If the property is an investment by the fiduciary under a will (as, for example, in the case of a sale by a fiduciary under a will of property transmitted from the decedent, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu to the fair market value at the time when the decedent died.

ARTICLE 117-2: Limitations on capital gains and capital losses. 1941-2-10561 I. T. 3440

REVENUE ACT OF 1932.

In view of G. C. M. 22491 [page 374, this Bulletin], I. T. 2892 (C. B. XIV-1, 148 (1935)) is modified to the extent that it is inconsistent therewith.

ARTICLE 117-2: Limitations on capital gains and capital losses. 1941-3-10567 Ct. D. 1480

INCOME TAX—REVENUE ACT OF 1934—DECISION OF SUPREME COURT.

1. DEDUCTION—CAPITAL LOSS—FORECLOSURE SALE.

A loss sustained by an individual taxpayer upon the foreclosure sale of his interest in real estate, acquired for profit, is not a loss which may be deducted in full from gross income under the provisions of section 23(e)2 of the Revenue Act of 1934, but is a capital loss, deductible only to the limited extent provided in sections 23(j) and 117(d) of that Act. The "sales" referred to in the statute include forced as well as voluntary sales of capital assets.

2. DECISION REVERSED.

Decision of the United States Circuit Court of Appeals, Sixth Circuit (1940) (108 Fed. (2d), 753), affirming unreported decision of the United States Board of Tax Appeals (1937), reversed.

SUPREME COURT OF THE UNITED STATES.

Guy T. Helvering, Commissioner of Internal Revenue, petitioner, v. *Godfrey Hammel and Pearl Hammel.*

[311 U. S., 504.]

On writ of certiorari to the United States Circuit Court of Appeals for the Sixth Circuit.

[January 6, 1941.]

OPINION.

Mr. Justice STONE delivered the opinion of the Court.

We are asked to say whether a loss sustained by an individual taxpayer upon the foreclosure sale of his interest in real estate, acquired for profit, is a loss which, under section 23(e)2 of the 1934 Revenue Act (48 Stat., 680), may be deducted in full from gross income for the purpose of arriving at taxable income, or is a capital loss deductible only to the limited extent provided in sections 23(e)2, (j), and 117.

In the computation of taxable income section 23(e)2 of the 1934 Revenue Act permits the individual taxpayer to deduct losses sustained during the year incurred in any transaction for profit. Subsection (j) provides that "losses from sales or exchanges of capital assets," shall be allowed only to the extent of $2,000 plus gains from such sales or exchanges as provided by section 117(d). By section 117(b) it is declared that "capital assets" "means property held by the taxpayer * * * but does not include stock in trade of the taxpayer * * * or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

Respondent taxpayers, with other members of a syndicate, purchased "on land contract" a plot of land in Oakland County, Mich., for the sum of $96,000, upon a down payment of $20,000. The precise nature of the contract does not appear beyond the fact that payments for the land were to be made in installments, and the vendor retained an interest in the land as security for payment of the balance of the purchase price. Before the purchase price was paid in full the syndicate defaulted on its payments. The vendor instituted foreclosure proceedings by suit in equity in a State court which resulted in a judicial sale of the property, the vendor becoming the purchaser, and in a deficiency judgment against the members of the syndicate. Respondents' contribution to the purchase money, some $4,000, was lost.

The Commissioner, in computing respondents' taxable income for 1934, treated the taxpayers' interest in the land as a capital asset and allowed deduction of the loss from gross income only to the extent of $2,000 as provided by sec-

tions 23(j) and 117(d), in the case of losses from sales of capital assets. The Board of Tax Appeals ruled that the loss was deductible in full. The circuit court of appeals affirmed (108 Fed. (2d), 753), holding that the loss established by the foreclosure sale was not a loss from a "sale" within the meaning of section 23(j). We granted certiorari (310 U. S., 619), to resolve a conflict of the decision below with that of the Court of Appeals for the Second Circuit in *Commissioner* v. *Electro-Chemical Engraving Co.* (110 Fed. (2d), 614) [Ct. D. 1482, page 380, this Bulletin].

It is not denied that it was the foreclosure sale of respondents' interest in the land purchased by the syndicate for profit, which finally liquidated the capital investment made by its members and fixed the precise amount of the loss which respondents seek to deduct as such from gross income. But they argue that the "losses from sales" which by section 23(j) are made deductible only to the limited extent provided by section 117(d) are those losses resulting from sales voluntarily made by the taxpayer, and that losses resulting from forced sales like the present not being subject to the limitations of section 117(d) are deductible in full like other losses under section 23(e)2.

To read this qualification into the statute respondents rely on judicial decisions applying the familiar rule that a restrictive covenant against sale or assignment refers to the voluntary action of the covenantor and not to transfers by operation of law or judicial sales *in invitum*. (See *Guaranty Trust Co.* v. *Green Cove & M. R. Co.*, 139 U. S., 137; *Gazlay* v. *Williams*, 210 U. S. 41; *Riggs* v. *Purcell*, 66 N. Y., 193.) But here we are not concerned with a restrictive covenant of the taxpayer, but with a sale as an effective means of establishing a deductible loss for the purpose of computing his income tax. The term sale may have many meanings, depending on the context, see Webster's New International Dictionary. The meaning here depends on the purpose with which it is used in the statute and the legislative history of that use. Hence the respondents argue that the purpose of providing in the 1934 Act for a special treatment of gains or losses from capital assets was to prevent tax avoidance by depriving the taxpayer of the option allowed to him by the earlier Acts, to effect losses deductible in full by sales of property at any time within two years after it was acquired, which until held for that period was not defined as a capital asset, section 208, Revenue Act of 1924 (43 Stat., 253); section 208, Revenue Act of 1926 (44 Stat., 19), and section 101 of the Revenue Act of 1928 (45 Stat., 811).

It is said that since losses from foreclosure sales not within the control of the taxpayer are not within the evil aimed at by the 1934 Act, they must be deemed to be excluded from the reach of its language. To support this contention respondents rely on the report of the Ways and Means Committee submitting to the House the bill which, with amendments not now material, became the Revenue Act of 1934. The committee in pointing out a "defect" of the existing law said: "Taxpayers take their losses within the 2-year period and get full benefit therefrom and delay taking gains until the 2-year period has expired, thereby reducing their taxes." (H. Rept. 704, Seventy-third Congress, second session, pages 9 and 10.)

But the treatment of gains and losses from sales of capital assets on a different basis from ordinary gains and losses was not introduced into the revenue laws by the 1934 Act. That had been a feature of every revenue law beginning with the Act of 1921 (42 Stat., 227), and each had defined as capital losses "losses from sales or exchanges of capital assets." The 1934 Act made no change in this respect but for the first time it provided that "capital assets" should include all property acquired by the taxpayer for profit regardless of the length of time held by him and that capital gains and losses from sales of capital assets should be recognized in the computation of taxable income according to the length of time the capital assets are held by the taxpayer, varying from 100 per cent if the capital asset is held for not more than a year to 30 per cent if it is held more than 10 years. (Section 117(a).) Finally, for the first time, the statute provided that capital losses in excess of capital gains should be deducted from ordinary income only to the extent of $2,000. Thus by treating all property acquired by the taxpayer for profit as capital assets and limiting the deduction of capital losses in the manner indicated, the Act materially curtailed the advantages which the taxpayer had previously been able to gain by choosing the time of selling his property.

The definition of capital losses as losses from "sales" of capital assets, as we have pointed out, was not new. As will presently appear, the legislative history of this definition shows that it was not chosen to exclude from the cap-

ital assets provisions losses resulting from forced sales of taxpayers' property. And, if so construed, substantial loss of revenue would result under the 1934 Act, whose purpose was to avoid loss of revenue by the application of the capital assets provisions. In drafting the 1934 Act the committee had before it proposals for stabilizing the revenue by the adoption of the British system under which neither capital gains nor losses enter into the computation of the tax. In declining to follow this system in its entirety the committee said: "It is deemed wiser to attempt a step in this direction without letting capital gains go entirely untaxed." It accordingly reduced the tax burden on capital gains progressively with the increase of the period up to 10 years, during which the taxpayer holds the capital asset, and permitted the deduction, on the same scale, of capital losses, but only to the extent that there are taxable capital gains, plus $2,000. In thus relieving capital gains from the tax imposed on other types of income, it can not be assumed, in the absence of some clear indication to the contrary, that Congress intended to permit deductions in full of losses resulting from forced sales of the taxpayers' property, from either capital gains or ordinary gross income, while taxing only a fraction of the gains resulting from the sales of such property. (See *White* v. *United States*, 305 U. S., 281, 292 [Ct. D. 1372, C. B. 1938-2, 238]; *Helvering* v. *Inter-Mountain Life Ins. Co.*, 294 U. S., 686, 689, 690 [Ct. D. 950, C. B. XIV-1, 339 (1935)].)

The taxation of capital gains after deduction of taxable losses on a more favorable basis than other income, was provided for by section 206 of the 1921 Revenue Act, as the means of encouraging profit-taking sales of capital investments (H. Rept. No. 350, Sixty-seventh Congress, second session, page 8. *Burnet* v. *Harmel*, 287 U. S., 103, 106 [Ct. D. 611, C. B. XI-2, 210 (1932)]). In this section, as in later Acts, capital net gain was defined as "the excess of the total capital gain over the sum of capital deductions, and capital losses"; capital losses being defined as the loss resulting from the sale or exchange of capital assets. In submitting the proposed Revenue Act of 1924, the House committee pointed out that the 1921 Act contained no provision for limiting deduction of capital losses where they exceeded the amount of capital gains. (H. Rept. No. 179, Sixty-eighth Congress, first session, page 14.) This was remedied by providing in section 208(c) that the amount by which the tax is reduced on account of a capital loss shall not exceed 12½ per cent of the capital loss. In commenting on this provision the committee said (page 10): "If the amount by which the tax is to be increased on account of capital gains is limited to 12½ per cent of the capital gain it follows logically that the amount by which the tax is reduced on account of capital losses shall be limited to the 12½ per cent of the loss." This provision was continued without changes now material until the 1934 Act. (Section 208(c) in the 1924 and 1926 Acts; section 101(b) in the 1928 and 1932 Acts; 47 Stat., 191.)

Congress thus has given clear indication of a purpose to offset capital assets by losses from the sale of like property and upon the same percentage basis as that on which the gains are taxed. (See *United States* v. *Pleasants*, 305 U. S., 357, 360 [Ct. D. 1379, C. B. 1939-1 (Part 1), 139].) This purpose to treat gains and deductible losses on a parity but with a further specific provision provided by section 117(d) of the 1934 Act, permitting specified percentages of capital losses to be deducted from ordinary income to the extent of $2,000 would be defeated in a most substantial way if only a percentage of the gains were taxed but losses on sales of like property could be deducted in full from gross income. This treatment of losses from sales of capital assets in the 1924 and later Acts and the reason given for adopting it afford convincing evidence that the "sales" referred to in the statute include forced sales such as have sufficed, under long accepted income tax practice, to establish a deductible loss in the case of noncapital assets. Such sales can equally be taken to establish the loss in the case of capital assets without infringing the declared policy of the statute to treat capital gains and losses on a parity.

We can find no basis in the language of the Act, its purpose or its legislative history, for saying that losses from sales of capital assets under the 1934 Act, more than its predecessors, were to be treated any differently whether they resulted from forced sales or voluntary sales. True, courts in the interpretation of a statute have some scope for adopting a restricted rather than a literal or usual meaning of its words where acceptance of that meaning would lead to absurd results (*United States* v. *Katz*, 271 U. S., 354, 362), or would thwart the obvious purpose of the statute (*Haggar* v. *Helvering*, 308 U. S., 389 [Ct. D. 1433, C. B. 1940-1, 237]). But courts are not free to reject that meaning where no such consequences follow and where, as here, it appears to be consonant

with the purposes of the Act as declared by Congress and plainly disclosed by its structure.

It is not without significance that Congress, in the 1934 Act, enlarged the scope of its provisions relating to losses from sales of capital assets by including within them losses upon the disposition of the taxpayer's property by methods other than sale and without reference to the voluntary action of the taxpayer. It thus treats as losses from sales or exchanges the loss sustained from redemption of stock (section 115(c)), retirement of bonds (section 117(f)), losses from short sales (section 117(e)1), and loss sustained by failure of the holder of an option to exercise it (section 117(e)2), although none of these transactions involves a loss from a sale. (See *McClain* v. *Helvering*, No. 55, decided this day [Ct. D. 1481, below].)

The scope of the capital loss provisions was still further enlarged by section 23(k)2 of the Revenue Act of 1938 (52 Stat., 447), which provides that if securities, which are capital assets, are ascertained to be worthless and are charged off within the taxable year the loss, with an exception not now material, shall be considered as a loss arising from a sale or exchange. These provisions disclose a consistent legislative policy to enlarge the class of deductible losses made subject to the capital assets provisions without regard to the voluntary action of the taxpayer in producing them. We could hardly suppose that Congress would not have made provision for the like treatment of losses resulting from a forced sale of the taxpayer's property acquired for profit either in the 1934 or 1938 Act, if it had thought that the term "sales or exchanges" as used in both Acts did not include such sales of the taxpayer's property.

Petitioners also advance the argument, sustained in *Commissioner* v. *Freihofer* (102 Fed. (2d), 787), that the definitive event fixing respondents' loss was not the foreclosure sale but the decree of foreclosure which ordered the sale and preceded it. But since the foreclosure contemplated by the decree was foreclosure by sale and the foreclosed property had value which was conclusively established by the sale for the purposes of the foreclosure proceeding, the sale was the definitive event establishing the loss within the meaning and for the purpose of the revenue laws. They are designed for application to the practical affairs of men. The sale, which finally cuts off the interest of the mortgagor and is the means for determining the amount of the deficiency judgment against him is a means adopted by the statute for determining the amount of his capital gain or loss from the sale of the mortgaged property.

The court below also thought that the loss suffered by respondents could not be treated as a loss from a sale since by the law of Michigan the vendor upon a land contract containing the usual forfeiture clause had the right to deprive respondents and their joint adventurers of all interest in the property by a declaration of forfeiture, and that the only additional advantage of foreclosure was to obtain a deficiency judgment. But there is nothing in this record to show that the land contract in this case contained a forfeiture clause. Even if it did, it does not appear that there was in fact a forfeiture apart from the sale on foreclosure. (Cf. *Davidson* v. *Commissioner*, 305 U. S., 44, 46 [Ct. D. 1366, C. B. 1938-2, 227]; *Helvering* v. *Midland Insurance Co.*, 300 U. S., 216, 224 [Ct. D. 1206, C. B. 1937-1, 178]; *United States* v. *Phellis*, 257 U. S., 156, 172 [Ct. D. 19, C. B. 5, 37 (1921)].)

Reversed.

Mr. Justice ROBERTS is of opinion that the judgment should be affirmed for the reasons stated in the opinion of the circuit court of appeals (108 Fed. (2d), 753).

ARTICLE 117-2: Limitations on capital gains and capital losses.

1941-3-10568
Ct. D. 1481

INCOME TAX—REVENUE ACT OF 1934—DECISION OF SUPREME COURT.

1. DEDUCTION—CAPITAL LOSS—RETIREMENT OF BONDS OR DEBENTURES.

Upon the surrender of bonds or debentures in exchange for a money payment less than cost, a taxpayer may not deduct the loss from his gross income as a bad debt under section 23(k) of the Revenue Act of 1934, but must treat it as a capital loss under section 117(f) of that Act, such transactions constituting "retirement of bonds, debentures, etc." The word "retirement" is broader in scope than "redemption" and is not limited to voluntary action on the debtor's

2. DECISION AFFIRMED.

Decision of the United States Circuit Court of Appeals, Fifth Circuit (1940) (110 Fed. (2d), 878), affirming unreported decision of the United States Board of Tax Appeals, affirmed.

3. DECISION REVERSED.

Decision of the United States Circuit Court of Appeals, Second Circuit (1940) (108 Fed. (2d), 642), reversing decision of the United States Board of Tax Appeals (1939) (40 B. T. A., 60), reversed.

SUPREME COURT OF THE UNITED STATES.

55. *Donald S. McClain, petitioner,* v. *Commissioner of Internal Revenue.*

On petition for writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

58. *Guy T. Helvering, Commissioner of Internal Revenue, petitioner,* v. *Florence Stanton Thomson, Executrix Under the Will of S. C. Thomson, Deceased.*

[311 U. S., 527.]

On petition for writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[January 6, 1941.]

OPINION.

Mr. Justice ROBERTS delivered the opinion of the Court.

These cases present the question whether upon the surrender of bonds or debentures in exchange for a money payment less than cost, a taxpayer may deduct the loss from his gross income as a bad debt under section 23(k)[1] or must treat it as a capital loss under section 117(f)[2] of the Revenue Act of 1934.

In No. 55 it appears that the taxpayer owned $15,000 par value of bonds of a water district, acquired by gift. The district being in financial difficulties offered to pay $7,476.75 for them. The offer was accepted and the bonds delivered. In his tax return the taxpayer claimed a deduction of $7,523.25 as for a bad debt charged off. The Commissioner disallowed the deduction, and the Board of Tax Appeals and the circuit court of appeals[3] sustained his ruling.

In No. 58 the facts are that the taxpayer bought $25,000 par value of debentures for $24,750. The issuer's affairs were placed in the hands of a receiver. A plan of reorganization provided that the receiver should pay $5 for each $1,000 debenture surrendered for cancellation. The taxpayer availed himself of this provision, and in his tax return claimed a deduction of $24,625, as for a bad debt. The Commissioner disallowed the claim, and the Board of Tax Appeals affirmed his decision. The circuit court of appeals reversed.[4]

By reason of the conflict of decision we granted certiorari in both cases.

The earlier Revenue Acts contained sections similar to 23(k) of the Act of 1934. They also embodied provisions for calculation of taxes on capital net gains. None of them included any section like 117(f). Prior to the adoption of the 1934 Act it had been held that the phrase "sale or exchange" of capital assets, employed in those Acts, was not descriptive of the redemption or call for repayment of corporate securities, and hence gain thereby occasioned was to be treated as ordinary income,[5] and loss so arising was to be deducted from gross income as a bad debt.[6]

The Revenue Act of 1934, by subsection (f) of section 117, provided that for the purposes of the title dealing with capital gains and losses, "amounts received

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[1] 48 Stat., 689; 26 U. S. C., section 23(k).
[2] 48 Stat., 715; 26 U. S. C., section 117(f).
[3] 110 Fed. (2d), 878.
[4] 108 Fed. (2d), 642.
[5] *Watson* v. *Commissioner* (27 B. T. A., 463); *Braun* v. *Commissioner* (29 B. T. A., 1161). This view was adopted by this Court as respects the Revenue Act of 1928, subsequent to the adoption of the Act of 1934. (*Fairbanks* v. *United States*, 306 U. S., 436 [Ct. D. 1391, C. B. 1939-1, 260].)
[6] *Commonwealth Bank* v. *Lucas* (41 Fed. (2d), 111 [Ct. D. 240, C. B. IX-2, 345 (1930)]); *Lebanon Nat. Bank* v. *Commissioner* (76 Fed. (2d), 792); *Pacific Nat. Bank* v. *Commissioner* (91 Fed. (2d), 103).

by the holder upon the retirement" of such securities as are here involved, "shall be considered as amounts received in exchange therefor."

It is plain that Congress intended by the new subsection (f) to take out of the bad debt provision certain transactions and to place them in the category of capital gains and losses. The question is whether by employing the word "retirement" the transactions here involved were so transferred. We hold that they were.

"Retirement" aptly describes what occurred in the instant cases. The statute does not use the word in an unusual or artificial sense. In common understanding and according to dictionary definition the word "retirement" is broader in scope than "redemption"; is not, as contended, synonymous with the latter, but includes it. Nothing in the legislative history of the provision requires us to attribute to the term used a meaning narrower than its accepted meaning in common speech.

The taxpayer in No. 58 urges that to hold subsection (f) applicable in his case would give the provision an unjust effect, since, if he had refused to surrender his debentures for the trifling consideration offered, he could have charged off their whole cost as a bad debt under section 23(k). The answer is that we must apply the statute as we find it, leaving to Congress the correction of asserted inconsistencies and inequalities in its operation.

The court below held in No. 58 that the phrase "retirement" could properly be applied only to voluntary action on the debtor's part in fulfillment of his promise to pay. This is but to say that retirement means no more than call and redemption pursuant to the terms of the obligation. But as we have said, the two are not in common understanding the same.

The judgment in No. 55 is affirmed, and that in No. 58 is reversed.

ARTICLE 117-2: Limitations on capital gains and capital losses.

1941-3-10569
Ct. D. 1482

INCOME TAX—REVENUE ACT OF 1934—DECISION OF SUPREME COURT.

1. DEDUCTION—CAPITAL LOSS—FORECLOSURE SALE.

A loss suffered by a corporation on foreclosure sale of its mortgaged property, acquired for profit, may not be deducted in full from gross income, but is a capital loss, deductible only to the extent provided by section 117(d) of the Revenue Act of 1934.

2. DECISION FOLLOWED.

Helvering v. *Hammel* [Ct. D. 1480, page 375, this Bulletin], decided by this Court on January 6, 1941, followed.

3. DECISION AFFIRMED.

Decision of the United States Circuit Court of Appeals, Second Circuit (1940) (110 Fed. (2d), 614), reversing unreported decision of the United States Board of Tax Appeals (1939), affirmed.

SUPREME COURT OF THE UNITED STATES.

Electro-Chemical Engraving Co., Inc., petitioner, v. *Commissioner of Internal Revenue.*

[311 U. S., 513.]

On writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[January 6, 1941.]

OPINION.

Mr. Justice STONE delivered the opinion of the Court.

This is a companion case to No. 49, *Helvering* v. *Hammel*, decided this day [Ct. D. 1480, page 375, this Bulletin].

The question is whether the loss suffered by petitioner on foreclosure sale of his mortgaged property, acquired for profit, may be deducted in full from gross

income or only to the extent provided by section 117(d) of the 1934 Revenue Act. The statutory provisions involved are those of the 1934 Act relating to capital gains or losses, particularly "losses from sales or exchanges of capital assets" considered in the Hammel case which are made applicable to petitioner, a corporation, by section 23(f)(j).

The Board of Tax Appeals ruled that petitoner's loss was deductible in full from its ordinary income. The Court of Appeals for the Second Circuit reversed the Board (110 Fed. (2d), 614), holding that the loss sustained by petitioner was a loss from a sale of capital assets (section 23(j)), which under section 117(d) could be deducted from the gross income only to the extent of capital gains, plus $2,000. We granted certiorari (310 U. S., 622), so that the case might be considered with the conflicting decision of the Court of Appeals for the Sixth Circuit in the Hammel case (108 Fed. (2d), 753). For the reasons stated in our opinion in the Hammel case we think that this case was rightly decided below.

Affirmed.

Mr. Justice ROBERTS dissents.

ARTICLE 117-3: Determination of period for which capital assets are held. 1941-16-10688 G. C. M. 22647

REVENUE ACTS OF 1921, 1924, 1926, 1928, AND 1932.

Stock acquired through the exercise of stock rights and sold within a period of two years, where the stock in respect of which the rights were issued had been held for more than two years, was in part a capital asset (the portion attributable to the rights) and in part a noncapital asset (the portion attributable to the subscription price).

G. C. M. 10063 (C. B. X-2, 159 (1931)) and G. C. M. 12942 (C. B. XIII-1, 73 (1934)) revoked to the extent inconsistent herewith. G. C. M. 11645 (C. B. XII-1, 117 (1933)) reinstated.

Recommended that I. T. 2609 (C. B. X-2, 339 (1931)) be revoked and that I. T. 1786 (C. B. II-2, 45 (1923)) be not reinstated.

An opinion is requested whether, in view of certain court decisions referred to herein, G. C. M. 10063 (C. B. X-2, 159 (1931)), G. C. M. 12942 (C. B. XIII-1, 73 (1934)), and I. T. 2609 (C. B. X-2, 339 (1931)) should be revoked, and G. C. M. 11645 (C. B. XII-1, 117 (1933)) and I. T. 1786 (C. B. II-2, 45 (1923)) should be reinstated.

The question involved is whether stock, which was acquired by the exercise of stock rights and sold within a period of two years after the exercise of the rights, was a capital asset within the meaning of the statute; or, to state it otherwise, where stock is acquired through the exercise of stock rights, is such stock acquired (1) as of the date on which the original stock (in respect of which the rights were issued) was acquired, (2) as of the date on which the rights were exercised, or (3) in part as of the first date and in part as of the second date?

In G. C. M. 12942, supra, it was held that where stock is acquired through the exercise of rights, the holding period begins on the date of acquisition of such stock and not on the date of acquisition of the stock with respect to which the rights were issued. That ruling revoked, in so far as inconsistent, G. C. M. 11645, supra, and reinstated G. C. M. 10063, supra, which was in accord with G. C. M. 12942, supra. In G. C. M. 11645, supra, it was stated in effect that stock acquired through the exercise of rights and held for less than two years, where the stock

in respect of which the rights were issued had been held for more than two years, was in part a capital asset (the portion attributable to the right) and in part a noncapital asset (the portion attributable to the subscription price). Under the ruling made in G. C. M. 12942, supra, which was based upon decisions of the Board of Tax Appeals on *Rodman E. Griscom* v. *Commissioner* (22 B. T. A., 979) and *Ellen Ayer Wood* v. *Commissioner* (29 B. T. A., 1050), no part of such stock was considered to be a capital asset.

The decision of the Board in the Griscom case, supra, earlier had resulted in the revocation of I. T. 1786, supra, which ruling had indicated that stock acquired through the exercise of rights, where the stock in respect of which the rights were issued was held for more than two years, constituted a capital asset. I. T. 1786 was revoked by I. T. 2609, supra, in conformity with G. C. M. 10063 and G. C. M. 12942, supra.

This question has now been considered by the courts (*Wood* v. *Commissioner*, 75 Fed. (2d), 364; *Macy* v. *Helvering*, 82 Fed. (2d), 183; *Insull* v. *Commissioner*, 87 Fed. (2d), 648), and the conclusions reached have been in substantial accord with G. C. M. 11645, supra.

The Board of Tax Appeals later recognized and followed the general rule established by the courts in the Wood case, the Macy case, and the Insull case, and stated that its prior decisions, in so far as in conflict, would not be followed in the future. (*Walter Fitch, Jr.*, v. *Commissioner*, 35 B. T. A., 537.)

In view of the fact that the ruling made in G. C. M. 11645, supra, is in harmony with the principles laid down in the above-cited court cases, that G. C. M. is reinstated, and G. C. M. 10063, supra, and G. C. M. 12942, supra, are revoked in so far as inconsistent therewith.

It is recommended that I. T. 2609, supra, be revoked and that I. T. 1786, supra, be not reinstated.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

ARTICLE 117–3: Determination of period for which capital assets are held. 1941–16–10689 I. T. 3469

REVENUE ACTS OF 1921, 1924, 1926, 1928, AND 1932.

In view of G. C. M. 22647 (page 381, this Bulletin), I. T. 2609 (C. B. X–2, 339 (1931)) is revoked, and I. T. 1786 (C. B. II–2, 45 (1923)) is not reinstated.

ARTICLE 117–4: Application of section 117 generally.

REVENUE ACT OF 1934.

Compensation received for loss of buildings, machinery, and equipment. (See Ct. D. 1510, page 324.)

SECTION 204(b).—INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL: DEFINITION OF INCOME, ETC.

ARTICLE 204(b)-1: Gross income of insurance companies other than life or mutual.

REVENUE ACTS OF 1921, 1924, 1926, 1928, 1932, AND 1934.

Reserves required by State authority with respect to noncancelable health and accident policies. (See G. C. M. 22503, page 265.)

ARTICLE 204(b)1: Gross income of insurance companies other than life or mutual. 1941-5-10581 Ct. D. 1483

INCOME TAX—REVENUE ACT OF 1926—DECISION OF COURT.

1. INSURANCE COMPANY OTHER THAN LIFE OR MUTUAL—"UNEARNED PREMIUMS"—ADDITIONAL RESERVE FOR NONCANCELABLE HEALTH AND ACCIDENT POLICIES—BASIS FOR COMPUTATION.

An insurance company other than life or mutual, issuing noncancelable accident and health policies the premiums on which were payable in a constant and fixed amount except for readjustment at a certain age, was entitled to include within "unearned premiums" the additional reserve for such policies as shown on its annual statement, in computing "earned premiums" for the taxable year 1926 in accordance with section 246(b)5 of the Revenue Act of 1926. The amount allocated to the additional reserve as of December 31, 1925, on the basis of 1921 computed experience (the only experience then known) was properly used in such computation rather than an amount based upon the experience of 1927-1929.

2. REHEARING DENIED.

Motion for rehearing denied August 21, 1940.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT.

Massachusetts Protective Association, Inc., plaintiff, appellant, v. *United States of America, defendant, appellee.*[a]

[114 Fed. (2d), 304.]

Appeal from the District Court of the United States for the District of Massachusetts.

Before MAGRUDER, MAHONEY, and PETERS, JJ.

[August 6, 1940.]

OPINION.

MAHONEY, J.: This is an appeal from a judgment of the district court in favor of the Government in a suit brought under the Tucker Act (24 Stat., 505 (1887), 28 U. S. C. A., section 41 (20)) by the Massachusetts Protective Association, Inc., a Massachusetts stock insurance corporation, to recover Federal income taxes assessed for the years 1926 and 1928 and collected by a collector who is now out of office. The case was tried upon a stipulation and a supplemental stipulation of facts, and upon oral testimony taken in open court. The facts as found by the district court from this evidence may be summarized as follows:

The plaintiff is a stock corporation organized under the laws of Massachusetts. During the calendar year 1926, the plaintiff was engaged, as it had been for many

[a] See G. C. M. 22503, page 265, this Bulletin.

years previously, in writing accident and health insurance in Massachusetts, New York and in a number of other States, and was taxable for 1926 as an insurance company, other than life or mutual, under the provisions of section 246 of the Revenue Act of 1926 [1] (44 Stat., 48, 26 U. S. C. A., Internal Revenue Acts, page 195).

Since 1919 the plaintiff has been issuing an accident and health policy which is noncancelable by the company and which the insured can keep in force until reaching the age of 70 simply by paying the premiums fixed in the policy. The premium on this type of policy from the date of issuance until the insured reached the age of 50 is in a constant and fixed amount which can not be increased by the company. The premium increases at 50, the amount of such increase being fixed in the policy, and thereafter remains constant and fixed.

The plaintiff includes with its annual income tax return an annual statement in the form approved by the National Convention of Insurance Commissioners setting forth its income and disbursements, assets and liabilities, and other pertinent information. By section 246(b)1 of the Revenue Act of 1926, this statement is made the basis for the computation of statutory gross income. With its income tax return for 1926 the plaintiff submitted a copy of the statement for that year. On this blank, on page 5, line 25, the plaintiff reports its *pro rata* unearned premiums, *i. e.*, the part of the net premiums received on all its policies proportioned to the unexpired term of the period for which the premiums were received. Of the last quarterly premiums paid on December 1, 1926, there was here reported 66⅔ per cent of the whole which was paid for protection to be rendered in January and February of 1927, plus any premiums paid in advance.

On the same page on line 25½, the plaintiff reports its "Additional Reserve on Non-Cancellable Health and Accident Policies" as of the last day of the taxable year. This reserve is set up as a liability of the company and is held to meet the additional hazards on noncancelable health and accident policies due to the fact that the premiums must remain constant while the risk and cost inevitably increase.

Before 1922, the plaintiff had on its books no additional reserve on noncancelable health and accident policies similar to that shown on line 25½ of its annual statement for later years. In March, 1923, the New York superintendent of insurance required such a reserve to be set up; and pending a determination of the proper size of such reserve as shown by its own experience, the plaintiff set up an arbitrary reserve of $75,000 as of December, 1922. This was increased each year thereafter because of the growth of sales of this type of contract until in December, 1925, on the basis of the 1921 computed experience, the reserve set up was $750,000. This was reported on line 25½ of the annual statement and was approved by the State insurance commissioner. In 1926, a further increase of $491,098.68 was made to the reserve of $750,000, and the total of $1,241,098.68 was reported on line 25½.

In arriving at its net income for 1926, the plaintiff was required to compute its earned premiums according to section 246(b)5 of the Revenue Act of 1926. In so doing the plaintiff added to its gross premiums written during the year (minus return premiums and premiums paid for reinsurance) its "unearned premiums" as of December 31, 1925, including in this amount both the *pro rata* unearned premiums, shown on line 25 of the 1925 statement, and the sum of $750,000, the additional reserve for noncancelable health and accident in-

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[1] SEC. 246. (a) In lieu of the tax imposed by section 230, there shall be levied, collected, and paid for each taxable year upon the net income of every insurance company (other than a life or mutual insurance company) a tax as follows:

(1) In the case of such a domestic insurance company, 12½ per centum of its net income;

* * * * * * *

(b) In the case of an insurance company subject to the tax imposed by this section—

(1) The term "gross income" means the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subdivision, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners;

(2) The term "net income" means the gross income as defined in paragraph (1) of this subdivision less the deductions allowed by section 247;

* * * * * * *

(4) The term "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred;

(5) The term "premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance. To the result so obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year;

* * * * * * *

surance, shown on line 25½ of the 1925 statement, and it deducted from the amount so obtained the *pro rata* unearned premiums, shown on line 25 of the 1926 statement, and the sum of $1,241,098.68, the additional reserve for noncancelable health and accident insurance, shown on line 25½ of the 1926 statement. In other words, as one of the items of net "unearned premiums" which the plaintiff is entitled to deduct from gross premiums written, the plaintiff deducted $491,098.68 which equaled the net addition to the additional reserve for noncancelable health and accident insurance between December, 1925, and December, 1926.

In 1930, an actuarial firm employed by the plaintiff completed a study of the plaintiff's experience in the years 1927–1929, and reported what the reserve should be for the coming year on the basis of that experience. It also informed the plaintiff that if the 1927–1929 experience had been known in December, 1925, the proper reserve at that time would have been $900,890 rather than the $750,000 based on the 1921 experience and actually held by the plaintiff.

Thereafter, in 1930, the Commissioner assessed against the plaintiff a deficiency in its 1926 income tax. A portion of this deficiency was made up by the Commissioner's determination that in computing the "earned premiums" according to section 246(b)5, the plaintiff should have taken as the reserve for December 31, 1925, shown on line 25½ of the statement for that year, the sum of $900,890 rather than the $750,000 actually held by the plaintiff and reported on line 25½, and accepted by the Commissioner in computing the 1925 tax. The result of this action by the Commissioner was to include in the plaintiff's "premiums earned" in 1926, the difference between $900,890 and $750,000, *i. e.*, $150,890. This difference resulted in an additional tax, plus interest, of $23,428.29. The plaintiff duly filed a claim for refund which was rejected and this suit was brought to recover the $23,428.29 with interest thereon.

The district court also found as a fact that in all of the plaintiff's tax returns, the Commissioner has allowed as an exclusion from gross income through the nine years between 1922 and 1930, the net increase in the additional reserve for noncancelable health and accident insurance except this amount of $150,890. Since 1930, the 1927–1929 experience has been used to figure the reserves set up, and the net increase in the aggregate reserves has been accepted each year by the Commissioner as an exclusion from gross income.

The refund for 1928 is claimed for the purely technical reason that a small portion of the $23,428.29 here sought to be recovered was not paid in cash but was a credit for an alleged 1928 overpayment which was applied by the Commissioner to the alleged 1926 deficiency. Since the defendant raised no question, either in the trial court or in this court, of the propriety of including this sum in the present suit, other than the general claim that it was not allowable as a deduction from gross income, we do not consider it necessary to pursue the matter further than to say that we consider it to be properly before us. (See *United States* v. *Bertelsen & Peterson Co.*, 306 U. S., 276 (1939) [Ct. D. 1387, C. B. 1939–1 (Part 1), 271].)

At the close of all the evidence, both the plaintiff and defendant moved for judgment in their favor, and the plaintiff requested the court to make certain findings of fact and conclusions of law. The judge denied the plaintiff's motion, and filed an opinion containing findings of fact and conclusions of law, giving judgment for the defendant. To the denial of its motion for judgment and the refusal to make the requested findings and conclusions, the plaintiff excepted.

Later the plaintiff moved to vacate the judgment and reopen the trial on the ground that the judge had erred in not allowing it to see his opinion and take exception to the denial of its motions and requests for findings before judgment was entered. The judge denied the motion and held that the exceptions previously taken safeguarded the plaintiff's rights on appeal. This court has held that the opinion in a case brought under the Tucker Act, supra, is a part of the record and exceptions taken to findings of fact and conclusions of law there made and to the judgment entered are duly taken during the course of the trial. (*United States* v. *Hyams*, 146 Fed., 15 (C. C. A. 1, 1906); *United States* v. *Swift*, 139 Fed., 225 (C. C. A. 1, 1905).) The first bill of exceptions was properly taken and is validly before this court. The district court properly denied the motion to vacate the judgment and reopen the trial.

The real question involved in the present controversy is whether the plaintiff in computing its "premiums earned" for the year 1926, under section 246(b)5

of the Revenue Act of 1926, was entitled to exclude therefrom the net addition made during that year to the additional reserve for noncancelable health and accident policies required by State laws. In other words, is this addition to the reserve fund a part of "unearned premiums" within the meaning of the above section?

The plaintiff contends that the words "unearned premiums" mean not only the *pro rata* portion of the premiums collected for the period which has yet to run, shown on line 25 of the annual statement, but, in addition, includes the annual additions to the reserve, set up on line 25½, to take care of the increased risk or additional cost of insurance in the later years of the insured's life. Where the policy is a level premium noncancelable policy, the plaintiff claims that some of the premiums collected in the early years are unearned and must be set up in this reserve to provide funds for paying the policy obligations in the later years when the cost of the insurance is greater than the level premium collected in those years. Since the plaintiff claims that the portion of the premiums so set aside is in fact unearned, it insists that it is deductible from gross premiums according to the method provided in section 246(b)5.

On the other hand, the defendant asserts that the words "unearned premiums" are strictly limited to that portion of the premiums covering the unexpired term of the period for which they are paid, *i. e.*, the *pro rata* unearned premiums, shown on line 25 of the annual statement. The main argument on which the Government rested its case is that the net addition to the additional reserve for noncancelable health and accident policies is no longer deductible from gross premiums in order to arrive at gross income, and that such net addition represents "earned premiums."

The district court gave judgment for the defendant on the ground that the net addition to the reserve was "earned premiums" within the meaning of section 246(b)5 and that Congress did not intend to allow this addition as a deduction. The district judge in his opinion stated that he could not find from the evidence that the total premium collected from the insured in any one period, even in the later years in which he is entitled to have his policy, is inadequate to take care of the risk or cost of insurance during that period; that when a quarterly premium was accepted, it was accepted for payment for insurance for three months only; that the company guaranteed nothing but that the policy would be kept in force for the next three months; and that the fact that the plaintiff was required to take some part of its earned or unearned premiums to set up a solvency reserve is of no importance as far as section 246(b)5 is concerned. He held that only the *pro rata* unearned premium, shown on line 25, was deductible. We can not agree with this disposition of the case.

The plaintiff's motion for judgment on all the evidence, in a case tried without a jury, is the equivalent of a motion for a directed verdict and raises a question of law whether the findings support the judgment and whether the findings are supported by evidence. (*Maryland Casualty Co.* v. *Jones*, 279 U. S., 792 (1929); *Griffin* v. *Thompson*, 10 Fed. (2d), 127 (C. C. A. 5, 1925); *Bank of Waterproof* v. *Fidelity & Deposit Co.*, 299 Fed., 478 (C. C. A. 5, 1924); *cf. Federal Intermediate Credit Bank* v. *L'Herisson*, 33 Fed. (2d), 841 (C. C. A. 8, 1929).) Though ordinarily the findings of fact in a trial without a jury are conclusive, where the proper motions are made and exceptions taken at the trial, and when, as here, the record contains all the testimony on which the findings are based, the appellate court can see if the findings are supported by evidence and, if not, can disregard them and reverse the judgment. (*Collier* v. *United States*, 173 U. S., 79 (1899); *United States* v. *Clark*, 96 U. S., 37 (1877); *Conners* v. *United States*, 141 Fed., 16 (C. C. A. 1, 1905); *cf. Kirk* v. *United States*, 163 U. S., 49, 56 (1896).) The cases cited by the defendant contain nothing to the contrary since they involve cases where the proper motions were not made at the trial to raise the question of lack of evidence.

In a noncancelable health and accident policy the premium remains level throughout the life of the policy (except perhaps for a readjustment, included in the policy, at a certain age, after which the premium is again level until the expiration of the policy) even though the risk insured against increases with the age of the insured and even though the claim costs in the later years of the policy are, therefore, correspondingly greater than those of the earlier years. It follows, therefore, that in each of the earlier years of a noncancelable policy the net annual premium collected exceeds the cost of the insurance for those years, while in each of the later years, the cost exceeds the net annual pre-

mium. Therefore, the additional reserve for noncancelable health and accident policies is set up and used to supplement the net annual premiums of such policies in the later years to the extent that the prospective cost in those years exceeds the net annual premiums. (*Equitable Life Assurance Society*, 33 B. T. A., 708 (1935).)

Jonathan Sharp, a witness for the plaintiff, in explaining the workings of this reserve, testified as follows:

"The simplest way to consider the reserve shown on line 25½ is to consider a simple noncancelable contract, the cost of insurance for the first year being $1, the second $2, the third $3, and the fourth $4, or a total of $10. You have an increasing cost of insurance on the average. If those premiums are paid $1 the first year, $2 the second, $3 the third, and $4 the fourth, there would be no additional reserve required, but if the premiums are paid $2.50 the first year, $2.50 the second year, $2.50 the third, and $2.50 the fourth, then $1.50 has to be set aside as an additional premium in advance or unearned in the first year, and 50 cents in the second, and they are used in the third and fourth years to make up the difference."

Here it is seen that if the policy is a noncancelable level premium policy, the annual premium contains, on a given date, two "unearned" portions, *e. g.*, the portion of actual cost for the period for which the premium is paid proportioned to the part of the period which has not yet expired, and that portion of the premium, over and above the actual cost of insurance for the period for which the premium is paid, which represents the amount which must be set aside in order to meet the excess of claims in later years over the level premium then collected. In the above example, suppose the $2.50 level premium is paid on July 1, 1925. On December 31, 1925, 50 cents of the $1 which the insurance for a year actually costs is unearned, since only one-half the protection has yet been given. This is the *pro rata* unearned premium reserve which is shown on line 25 of the annual statement. However, there is another sum which is also "unearned," *i. e.*, the $1.50 which was collected as part of the premium but which is in excess of the actual cost of the insurance and must be put into the additional reserve for noncancelable health and accident insurance to pay the excess cost above the premium collected in the third and fourth years of the illustration. This is shown on line 25½ of the annual statement.

In the case at bar, the *pro rata* unearned premium reserve merely represented the amount of the premiums collected which had not been earned because the period for which protection had been bought had not yet entirely elapsed. The additional reserve represented the extra amount included in the premium, made necessary by the fundamental principles of noncancelable (or guaranteed renewable) insurance, to make up what experience had shown to be the excess of the cost of the insurance in later years over the level premium collected in those years. The entire premium of a noncancelable health and accident insurance policy could not be wholly earned at the end of the period for which it was paid and be used by the plaintiff in any way it pleased, for by the very nature of the insurance a portion of the premium represents payment now for future coverage at a time when the premium is not sufficient to pay the cost of the insurance.

The reason that this reserve must be set up is that the plaintiff has guaranteed not to increase the premium as the cost of the insurance increases, and to renew the policy automatically on the payment of each succeeding level premium. Without this guarantee the policy would have been a simple nonrenewable accident and health policy, on which there would have been no need for an additional reserve since the premium could have been raised at the end of each period to correspond with the risk and cost of the insurance for the coming period, and thus would have been wholly earned at the expiration of the period. The difference is exactly that which exists between a 1-year term policy of life insurance and a renewable term policy with level premium. (See Huebner, Life Insurance (1923), 8, *et seq.*)

The statements in the conclusions of law suggest that, as a matter of fact, the total premium collected in any period is never inadequate to pay the cost of the insurance for that year, that the plaintiff guaranteed nothing more than to keep the policy alive for the next three months, and that the *pro rata* unearned premiums were in fact the only portion of the premiums unearned. We do not believe these statements can be harmonized with the uncontradicted evidence and the nature of noncancelable health and accident insurance. (See Craig, The Actuarial Basis for Premiums and Reserves in Personal Accident and Health Insurance (1931), 17 Proceedings of the Casualty Actuarial Society, 51,

66–67; Laird, Non-Cancellable Accident and Health Insurance Underwriting Problems (1921), 7 id., 302, 316–318; Maverick, "Rates and Reserves for Non-Cancellable Health and Accident Policies" (1921), 3.) In so far as the conclusions of law hold that the additional reserve for noncancelable policies are not, as a matter of law, to be included in the phrase "unearned premiums" in section 246(b)5 of the Revenue Act of 1926, they are in our opinion erroneous.

Unless the contrary appears, statutory words are presumed to be used in their ordinary and natural meaning. (*Helvering* v. *San Joaquin Co.*, 297 U. S., 496 (1936); *DeGanay* v. *Lederer*, 250 U. S., 376 (1919) [T. D. 2876, C. B. 1, 98 (1919)].) And where the applicable section deals with a particular trade or business, as insurance, the technical insurance terms must be considered to be used in the sense in which such terms are generally used or understood in the insurance business. (*Travelers Equitable Insurance Co.*, 22 B. T. A., 784 (1931); see G. C. M. 2318, C. B. VI–2, 80, 81 (1927); Hearings before the Senate Finance Committee, on H. R. 8245, Sixty-seventh Congress, first session (1921), 394.)

The uncontradicted oral testimony in this case shows that in the insurance business the term "unearned premiums" includes more than the *pro rata* portion, shown on line 25, and specifically includes the reserve for noncancelable health and accident policies, shown on line 25½. Before Congress passed the Revenue Act of 1921 (42 Stat., 227), insurance authorities had publicly recognized that this reserve was a part of unearned premiums. (See, *e. g.*, Laird, Maverick, supra.) It thus appears that at the time when the statute was first enacted it was well understood that this particular reserve was included in the technical term "unearned premiums" used by Congress.

That the term was so understood appears even more clearly from an examination of the blank of the National Convention of Insurance Commissioners, which is made the test of gross income by section 246(b)1 of the Revenue Act of 1921, supra, and the corresponding section of each successive Act. At the time the Revenue Act of 1921 was adopted, the blank contained only line 25 for the entry of unearned premiums. In 1922, line 25½ was added to provide a space for segregating the reserve which was only necessary for noncancelable health and accident policies. (See Proceedings of the National Convention of Insurance Commissioners (1922), 41, 50.) The ordinary cancelable policies had no unearned premium except the *pro rata* reserve and needed no line 25½ reserve. It is significant that the new line was numbered 25½, indicating that it was a subdivision of line 25, and that it was denominated an "additional reserve." To make it even clearer that in finding "premiums earned" the *pro rata* reserve of line 25 and the additional reserve of line 25½ should be deducted, explicit instructions to that effect were put on page 8 of the blank dealing with the computation of "premiums earned." (See Proceedings of the National Convention of Insurance Commissioners (1924), 175, 190.) The fact that there was no specific line showing this particular item separately at the time the Revenue Act of 1921 was enacted does not mean that Congress did not intend to include this reserve in the term "unearned premiums" as then understood. (*Home Title Insurance Co.* v. *United States*, 50 Fed. (2d), 107, 111 (C. C. A. 2, 1931).) When the Revenue Act of 1926 reenacted section 246(b)1 providing that "gross income" should be computed on the basis of the statement of the National Convention of Insurance Commissioners, the blank, as shown above, expressly provided for the deduction of the additional reserve for noncancelable health and accident insurance in arriving at "earned premiums." Congress, in reenacting this section, must have been referring to this current statement including the deduction of this reserve.

The close analogy of noncancelable health and accident insurance, where the risk increases and the premium remains constant, to renewable term level premium life insurance has already been noted. In Travelers Equitable Insurance Co., supra, a life insurance company was taxed under section 246 of the Revenue Acts of 1921 and 1924 (identical with the same section of the 1926 Act) as an insurance company, other than life or mutual, as it did not come within the definition of a life insurance company set out in section 242 so as to be taxed as such under section 242–245. The Board of Tax Appeals held that its life insurance reserves, built up from the excess of the early level premiums over the cost of the insurance to compensate for the later excess of cost over premium, precisely as the noncancelable health and accident reserves are calculated, were "unearned premiums" within the meaning of section 246(b)5 and should be added to the *pro rata* unearned premium reserve for ordinary cancelable casualty policies. The question presented was analogous to the question here, and the Commissioner announced his formal acquiescence in the decision. (C. B. X–2, 71 (1931).) We agree with the conclusion of the Board that the holding "is in no way

inconsistent with the wording or the purpose of that section [section 246] and is economically sound." The decision and reasoning are directly applicable here.

The defendant, however, contends that the additional reserve for noncancelable health and accident policies is not to be added to unearned premiums in computing gross income, because Congress in the Revenue Act of 1926 made no provision for the deduction from gross premiums of insurance companies, other than life or mutual, of the net addition to reserve funds required by law, which had been allowed to all insurance companies prior to the Revenue Act of 1921.

Close examination of the provisions of the Revenue Act of 1921 relating to insurance (which were reenacted in the Revenue Acts of 1924 and 1926), and of their legislative history, discloses that no departure was made from the previous system of taxing only the "earned premiums" of insurance companies. This had previously been accomplished by including all premiums in gross income and allowing the unearned portion represented by the net addition to reserve funds to be deducted. The new statute simply continued the same system, as far as insurance companies other than life or mutual were concerned, by defining underwriting income as "premiums earned" and providing for the computation of those premiums in section 246(b)5 by subtracting from gross premiums the "unearned premiums" which were still represented by the same reserves. (*Utah Home Fire Insurance Co.* v. *Commissioner*, 64 Fed. (2d), 763 (C. C. A. 10, 1933), certiorari denied, 290 U. S., 679 (1933).) Section 246(b)5 in no way prevents the deduction of the net addition to reserve funds required by law if the addition represents unearned premiums.

Furthermore, any contention of the defendant that section 246(b)5 prevents the deduction of the net addition to reserve funds required by law proves too much. The *pro rata* unearned premium reserve is the original basic reserve fund required by law for all types of insurance. (*Maryland Casualty Co.* v. *United States*, 251 U. S., 342, 348 (1920); *cf. Central National Fire Insurance Co.*, 22 B. T. A., 1054 (1931).) The defendant's argument would prevent this reserve from being deducted, yet the *pro rata* premium reserve is unquestionably deductible from gross premiums to find premiums earned.

Finally, the defendant proposes that the additional reserve on noncancelable health and accident policies can not be unearned premiums because if a policy is canceled by an insured he receives no surrender value and the plaintiff keeps the excess reserve accumulated.

Whether a premium is considered earned or unearned depends upon the nature of the risk and policy involved. (*American Title Co.*, 29 B. T. A., 479 (1933), affirmed 76 Fed. (2d), 332 (C. C. A. 3, 1935) [Ct. D. 992, C. B. XIV-2, 254 (1935)].) Fire and ordinary casualty insurance premiums become fully earned as soon as the period for which the premium was paid has expired, for the risk expires at the same time; but a title insurance premium is fully earned the moment it is paid although the risk continues indefinitely. (*American Title Co.*, supra.) And marine insurance premiums are often not considered earned until the entire risk has expired. (See Mass. Gen. Laws (Ter. ed., 1932), ch. 175, section 10; Huebner, Property Insurance (1927), 355.)

The surrender value of a life insurance policy is never the full value of the insurance reserve but is diminished by a surrender charge, and the payment on cancellation of a fire insurance policy is not the total of the *pro rata* unearned premium but that amount minus the customary monthly short rate. (See Mass. Gen. Laws (Ter. ed., 1932), ch. 175, sections 99, 144.) Thus, the "unearned premium" can not be tested by what the company must return on cancellation.

Congress is only interested in determining what part of a company's gross income should be treated as net income for the purposes of taxation. (*McCoach* v. *Insurance Co. of North America*, 244 U. S., 585.) In general, premium income is not such, and its inclusion in gross income is only justified by the deductions allowed. (See Hearings before the Committee on Ways and Means on the Revenue Act of 1918, Sixty-fifth Congress, second session, Part 1 (1918), 811.) The additional reserve for noncancelable health and accident policies, whether returnable to the insured or not, is not available for the use of the general purposes of the plaintiff. It is held as a liability to provide for the payment or reinsurance of specific contingent insurance liabilities proven by experience to be a part of the cost of this particular type of insurance in the future years. When an insured cancels his policy, or when the plaintiff reinsures its risks or pays a claim, the sums represented by the reserve on the

ıınceled policy or the claims, or the total reserve in the case of reinsurance, o longer remain in the reserve but become a part of "gross income" within ıe meaning of the statute. (*Cf. Central National Fire Insurance Co.*, supra; *nion Underwriters of New York et al.*, 4 B. T. A., 472 (1926).) And the me that portions of premiums which have been set aside in true insurance :serves can be included in gross income is "only where it is clearly shown ıat subsequent business conditions have released the amount of them to the 'ee beneficial use of the company in a real, and not in a mere bookkeeping ense." (*Maryland Casualty Co.* v. *United States*, supra, at 353.)

As long as these reserve funds must be held to provide for expected in- ırance liabilities in the future on these noncancelable health and accident olicies and are not to be used for the general purposes of the company, they :e not "earned premiums" within the meaning of Congress and not includible ı gross income. The test is not whether the part of the premium set aside ı the reserve for noncancelable health and accident insurance "belongs" to ıe company in the event of cancellation or lapsing of the policy, but whether ıat amount is such a part of the company's gross income as Congress con- dered should be treated as net income for the purposes of taxation. (*McCoach Insurance Co. of North America*, supra.) We hold that it is not.

The practically unbroken administrative practice of allowing the inclusion of ıis reserve as unearned premiums in section 246(b)5, both in the case of the aintiff and as generally conceded by the defendant in its answer to the otion to reverse and remand, plus the reenactment of the relevant portions the statute eight times, and the Commissioner's acquiescence in the analogous ıse of *Travelers Equitable Insurance Co.*, supra, should settle the case un- ıestionably. (See *Haggar* v. *Helvering*, 308 U. S., 389 (1940) [Ct. D. 1433, B. 1940-1, 237]; *Helvering* v. *Wilshire Oil Co.*, 308 U. S., 90, 100 (1939) [Ct. . 1424, C. B. 1939-2, 213]; *Alaska Steamship Co.* v. *United States*, 290 U. S., 6, 262 (1933); *Edward's Lessee* v. *Darby*, 12 Wheat., 206, 210 U. S., 1827.)

The plaintiff is clearly entitled to include the additional reserve for non- ncelable health and accident policies, shown on line 25½ of its annual state- ent, in "unearned premiums" in computing its "earned premiums" in cordance with section 246(b)5 of the Revenue Act of 1926.

The only question which remains is whether the Commissioner was correct assessing a deficiency on the ground that the plaintiff should have used the amount for the additional reserve at the end of 1925 the $900,890 which e experience of 1927-1929 indicated would have been the proper amount of e reserve at that time if the subsequent experience had been known, rather an the $750,000 which was the actual amount allocated to the reserve on e basis of the 1921 experience, the only experience then known. We think e Commissioner was wrong.

It is stipulated that the Commissioner used the figure of $750,000 in com- ıting the plaintiff's tax for 1925. The effect of substituting, in 1930, the sum $900,890 in place of $750,000 as the reserve held on December 31, 1925, computing the 1926 tax is to include in "premiums earned" for 1926 the fference between those two amounts, or $150,890, representing an additional x plus interest of $23,428.29. This $150,890 was a part of the actual addi- ɔn made to the reserve funds between December 31, 1925, and December , 1926, based on the experience of 1921. The reserves of 1925 and 1926 ere both accepted as proper by the Commissioner and the various State surance departments. That the fund as of December 31, 1925, should have ıounted to $900,890 was not known and could not have been known until 30. Any amount held in the reserve between 1925 and 1930, as shown above, not "earned premiums" within the meaning of the statute but is "un- rned premiums." This $150,890 was so held in the reserve, and is, therefore, ınearned premiums." The Commissioner had no right to include it in the ıintiff's gross income.

The additional reserve for noncancelable health and accident policies is operly includible within the term "unearned premiums" as used in section 6(b)5 of the Revenue Act of 1926. The plaintiff in 1926 used the proper ure for said additional reserve as of December 31, 1925, in computing the ınearned premium" in accordance with section 246(b)5. Therefore, the de- iency of $23,428.29 assessed by the Commissioner because he included the 50,890 above referred to in the plaintiff's gross income as "earned premiums"

for 1926 was erroneous. The district court should have granted the plaintiff's motion for judgment.

In the view we take of the construction of section 246(b)5 of the Revenue Act of 1926, and in the light of the defendant's answer to the motion it is not necessary to consider the plaintiff's motion to reverse and remand for a new trial to establish the administrative practice, and the motion is accordingly denied.

The judgment of the district court is reversed and the cause remanded to that court with direction to enter judgment for the plaintiff in the sum of $23,428.29 with interest from July 15, 1931.

SUPPLEMENT L.—ASSESSMENT AND COLLECTION OF DEFICIENCIES.

SECTIONS 275 AND 276.—PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

ARTICLE 275–2: Period of limitation upon collection of tax. (Also Section 292.)

1941–23–10738
Ct. D. 1518

INCOME TAX—REVENUE ACT OF 1917—DECISION OF SUPREME COURT.

1. SUIT—BOND—POWER OF COLLECTOR TO RELEASE OBLIGATION.

A collector of internal revenue who accepted a surety bond filed with him by a taxpayer to accompany his claim for abatement of additional income tax for the year 1917, assessed in 1920, did not have power to release the obligation of the bond.

2. SUIT—BOND—LIABILITY OF SURETY FOR INTEREST AND DAMAGES—EFFECT OF STATE STATUTE FIXING INTEREST RATE.

Where a surety bond is conditioned on the payment of tax plus interest and only the tax is paid, the surety is liable not only for interest on the unpaid tax to the date of rejection of the claim for abatement but also for damages, expressed in terms of interest, for nonpayment of the amount found to be due, the amount of such damages to be determined by the court. While a State statute fixing the rate of interest at 6 per cent is not controlling, it is, under the circumstances of the case, a suitable rate.

3. DECISION AFFIRMED.

Decision of the United States Circuit Court of Appeals, Second Circuit (1940) (116 Fed. (2d), 247), affirmed.

SUPREME COURT OF THE UNITED STATES.

The Royal Indemnity Co., petitioner, v. *The United States of America.*
[61 S. Ct., 995.]

On writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[May 26, 1941.]

OPINION.

Mr. Justice STONE delivered the opinion of the Court.

A collector of internal revenue, who had accepted a surety bond filed with him by a taxpayer to accompany his claim for abatement of income tax,

consented to termination of all liability upon the bond and surrendered it before its obligation was fully satisfied. The questions for decision are whether the collector had power to release the obligation of the bond and, if not, whether the United States is entitled to interest on the amount of its claim against the surety.

Upon the Commissioner's assessment in 1920 of additional income taxes in the sum of $29,128, asserted to be due from the taxpayer for 1917, the taxpayer filed a claim for abatement of the assessment, and to secure suspension of collection of the tax, executed a bond to the collector in the sum of $38,000 with petitioner as surety, conditioned upon payment on May 2, 1923, of the tax with interest. The Commissioner allowed the claim in abatement in part but rejected it to the extent of $8,223.38, on which interest had then accrued in the sum of $4,169.07. On demand of the Commissioner on August 5, 1926, for the principal amount of the tax with interest to the date of demand, petitioner paid only the principal amount of the tax to the collector by draft of December 17, 1926, bearing the notation on its face that it was in full payment of the tax and of all liability on the bond. The collector collected the draft and surrendered the bond to petitioner with the statement that all liability on it had terminated.

In the present suit on the bond the district court held that the collector was without authority to release the bond and gave judgment for the sum of $4,169.07 found by the Commissioner to be the interest on the unpaid tax to the date of the rejection of the claim for its abatement, but refused to allow interest accruing subsequent to that date. On appeal the circuit court of appeals ruled that under section 370 of the New York General Business Law, interest at 6 per cent should be added to the unpaid balance found to be due on the bond and modified the judgment accordingly. (116 Fed. (2d), 247.) We granted certiorari April 7, 1941, because of the importance of the questions presented, and of a conflict of the decision below with that of the Circuit Court of Appeals for the Third Circuit in *Heinemann Chemical Co.* v. *United States* (92 Fed. (2d), 302).

It is not denied that the collector had authority to accept the bond, that it created a new cause of action distinct from that on the taxpayer's obligation, and that if it has not been released, the United States has authority to sue upon it (see *United States* v. *John Barth Co.*, 279 U. S., 370; *Gulf States Steel Co.* v. *United States*, 287 U. S., 32; *United States* v. *Wolper*, 86 Fed. (2d). 715; *United States* v. *Oswego Falls Corporation*, 113 Fed. (2d), 322). And it is conceded that, as the bond was conditioned on the payment of the taxes with interest, petitioner is indebted to the Government upon it for the amount of the interest which had accrued at the time of the rejection of the claim in abatement. (See *Botany Worsted Mills* v. *United States*, 278 U. S., 282 [Ct. D. 39, C. B. VIII–1, 279 (1929)]; *Hughson* v. *United States*, 59 Fed. (2d), 17, 19; *United States* v. *Steinberg*, 100 Fed. (2d), 124, 126.) Respondent's contentions are that the balance of interest then due was released by the collector and that in any case it was not bound to pay interest on that balance.

Power to release or otherwise dispose of the rights and property of the United States is lodged in the Congress by the Constitution. (Article IV, section 3, clause 2.) Subordinate officers of the United States are without that power, save only as it has been conferred upon them by Act of Congress or is to be implied from other powers so granted. (*Whiteside* v. *United States*, 93 U. S., 247, 256–257; *Hart* v. *United States*, 95 U. S., 316, 318; *Hawkins* v. *United States*, 96 U. S., 689, 691; *Utah Power & Light Co.* v. *United States*, 243 U. S. 389, 409; *Wilber Nat. Bank* v. *United States*, 294 U. S., 120, 123–124; cf. *United States* v. *Shaw*, 309 U. S., 495, 501; *Ritter* v. *United States*, 28 Fed. (2d), 265; *United States* v. *Globe Indemnity Co.*, 94 Fed. (2d), 576.) Collectors of internal revenue are subordinate officers charged with the ministerial duty of collecting the taxes. (R. S., section 3183; *Erskine* v. *Hohnbach*, 14 Wall., 613, 616; *Hardy* v. *Woodcock*, 137 U. S., 43, 46; *Moore Ice Cream Co.* v. *Rose*, 289 U. S., 373, 380, 381.) There is no statute in terms authorizing them to remit taxes, to pass upon the claims for abatement of taxes or to release any obligation for their payment. Only the Commissioner, with the consent of the Secretary of the Treasury, is authorized to compromise a tax deficiency for a sum less than the amount lawfully due. (R. S., sections 3220, 3229; 26 U. S. C., 1661; Treasury Regulations 45, article 1011 (1918 Act); *Botany Worsted Mills* v. *United States*, supra, 288; *Loewy & Sons* v. *Commissioner*, 31 Fed. (2d), 652, 654.)

There is thus no basis in the statutes of the United States for implying an authority in a collector to release a bond for the payment of the tax which the Commissioner alone is permitted to reduce by way of compromise when the Secretary of the Treasury consents. *Heinemann Chemical Co.* v. *United States*, supra, and *Brewerton* v. *United States* (9 Fed. Supp., 503), to the contrary, plainly rest upon a misapplication of the ruling in *United States* v. *Alexander* (110 U. S., 325), which sustained the release of a bond for taxes by the Secretary of the Treasury which had been specifically authorized by an Act of Congress.

The district court rejected the Government's claim for interest upon the balance found due upon the bond as a demand for interest on interest which has generally been held not to be an appropriate measure of damages for the delayed payment of interest alone. (See *Cherokee Nation* v. *United States*, 270 U. S., 476, 490.) In any case it thought that the allowance of interest would be inequitable because of the collector's return of the bond to petitioner and the Government's delay in bringing the suit. But, as the court of appeals held, the obligation of petitioner to pay the interest accrued on the principal amount of tax under the applicable provisions of the Revenue Act was not damage assessed against petitioner for its nonpayment of interest. Petitioner's obligation was contractual to pay an amount found to be due from the taxpayer and the suit against it is for a debt *ex contractu*, due and owing in conformity to the terms of the bond. See *United States* v. *John Barth Co.*, supra; *Gulf States Steel Co.* v. *United States*, supra.

A suit upon a contractual obligation to pay money at a fixed or ascertainable time is a suit to recover damage for its breach, including both the principal amount and interest by way of damage for delay in payment of the principal, after the due date. And in the absence of any controlling statutory regulation the trial court is as competent to determine the amount of interest for delay as any other item of damage. (*United States* v. *United States Fidelity Co.*, 236 U. S., 512, 528; *Young* v. *Godbe*, 15 Wall., 562, 565; *Maryland Casualty Co.* v. *United States*, 76 Fed. (2d), 626; *United States* v. *Wagner*, 93 Fed. (2d), 77; *United States* v. *Hamilton*, 96 Fed. (2d), 878; *Massachusetts Bonding & Ins. Co.* v. *United States*, 97 Fed. (2d), 879, 881.)

But the rule governing the interest to be recovered as damages for delayed payment of a contractual obligation to the United States is not controlled by State statute or local common law. In the absence of an applicable Federal statute it is for the Federal courts to determine, according to their own criteria, the appropriate measure of damage, expressed in terms of interest, for nonpayment of the amount found to be due. (*Board of Commissioners, Jackson County*, v. *United States*, 308 U. S., 343, 350, 352; *Young* v. *Godbe*, supra, 565; cf. *Billings* v. *United States*, 232 U. S., 261, 284, *et seq.*)

The present suit is at law for the recovery of an amount due and owing which petitioner has contracted to pay. To such a case equitable rules relating to interest recoverable in suits for an accounting, or for the recovery of quasi contractual obligations arising from payment of money by mistake, are inapplicable. (*United States* v. *United States Fidelity Co.*, supra, 528; cf. *Redfield* v. *Ystalyfera Iron Co.*, 110 U. S., 174, 176; *United States* v. *Sanborn*, 135 U. S., 271, 281; *Redfield* v. *Bartels*, 139 U. S., 694, 702.) Here responsibility for delay in payment rests quite as much upon the debtor, who is chargeable with knowledge of its own obligation and the breach of it, as upon the creditor. And in the meantime the debtor has had the use of the money, of which its default has deprived the creditor. Interest upon the principal sum from the date of default, at a fair rate, is therefore an appropriate measure of damage for the delay in payment. (*United States* v. *United States Fidelity Co.*, supra, 528; *Massachusetts Bonding & Insurance Co.*, supra; *United States* v. *Wagner*, supra; *Maryland Casualty Co.* v. *United States*, supra.) While the New York statute fixing the rate of interest is not controlling, the allowance of interest does not conflict with any State or Federal policy and we think that in the circumstances of this case a suitable rate is that prevailing in the State where the obligation was given and to be performed. (See *Young* v. *Godbe*, supra, 565; *Board of Commissioners, Jackson County*, v. *United States*, supra, 352.)

Affirmed.

SUPPLEMENT M.—INTEREST AND ADDITIONS TO THE TAX.

SECTION 292.—INTEREST ON DEFICIENCIES.

REVENUE ACT OF 1917.

Liability of surety on a bond for interest and damages expressed in terms of interest. (See Ct. D. 1518, page 391.)

SUPPLEMENT O.—OVERPAYMENTS.

SECTION 322.—REFUNDS AND CREDITS.

ARTICLE 322-7: Limitations upon the crediting and refunding of taxes paid. 1941-23-10737 Ct. D. 1517

INCOME TAX—REVENUE ACT OF 1926—JUDICIAL CODE—DECISION OF SUPREME COURT.

1. SUIT—RECOVERY OF OVERPAYMENT OF TAX—LIMITATION PERIOD.

In a suit to recover an internal revenue tax alleged to have been erroneously or illegally assessed or collected, the specific period of limitation of five years after payment of the tax, or two years after disallowance of claim for refund or credit, provided in section 1113(a) of the Revenue Act of 1926, is applicable, not the general 6-year limitation period provided in section 24(20) of the Judicial Code.

2. ACCOUNT STATED.

Even though the period of limitation specified in section 24(20) of the Judicial Code applies to an account stated, a certificate of overassessment noting that a portion of a claim for refund is barred by the statute of limitations, with which was inclosed a check for the balance of the claim, does *not* constitute an account stated as to the portion said to be barred.

3. CASE DISTINGUISHED.

Bonwit Teller & Co. v. *United States* (1931) (283 U. S., 258 [Ct. D. 334, C. B. X-1, 328 (1931)]) distinguished.

4. DECISION REVERSED.

Decision of the United States Circuit Court of Appeals, Third Circuit (1938) (97 Fed. (2d), 387), reversed.

SUPREME COURT OF THE UNITED STATES.

The United States of America, petitioner, v. *The A. S. Kreider Co., respondent.*
[61 S. Ct., 1007.]

On writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit.

[May 26, 1941.]

OPINION.

Mr. Justice MURPHY delivered the opinion of the Court.

In 1921, respondent filed its income tax return for 1920, disclosing tax liability of $52,481.97 which it paid in full. Thereafter, and prior to June 15, 1926, it executed a waiver extending until December 31, 1926, the time for audit and possible additional assessment of taxes. On July 26, 1926, respondent paid a deficiency assessment of $1,362.50. Almost three years later, on March 23, 1929,

respondent filed a claim for refund of $53,844.47, the entire amount of taxes paid for 1920.

The Commissioner found that respondent had overpaid its 1920 taxes in the sum of $14,833.68. In October, 1929, he sent respondent a certificate of overassessment which noted that there had been an overpayment in that amount but that $13,471.18 was "barred by statute of limitations." Accompanying the certificate was a check for the difference, $1,362.50, which respondent apparently accepted. In thus computing the refund owing to respondent, the Commissioner assumed that subsections (b)(1), (b)(2), and (g) of section 284[1] of the Revenue Act of 1926 (44 Stat., 9, 66, 67) authorized him to remit only that part of the 1920 tax which was paid in 1926.

On March 7, 1932, respondent brought the present action in a United States district court to recover the sum withheld. At the close of the trial, petitioner moved for judgment on the ground that the action was barred by section 1113(a) of the Revenue Act of 1926 (44 Stat., 9, 116). The district court granted the motion and entered judgment for petitioner. (30 Fed. Supp., 722.) The circuit court of appeals reversed, one judge dissenting, holding that the general 6-year limitation in section 24(20) of the Judicial Code [28 U. S. C., section 41(20)] rather than the limitations in section 1113(a) determined the timeliness of respondent's action. (97 Fed. (2d), 387.)

The cause was returned to the district court. Over the renewed contention of petitioner that the action was barred by section 1113(a), the district court proceeded to the merits. It held, in effect, that section 284(b)2 did not limit the refund sanctioned by section 284(g) to the portion of the tax paid within four years of respondent's claim, and entered judgment as prayed in the complaint. (30 Fed. Supp., 724.) The circuit court of appeals affirmed, accepting as the law of the case its earlier decision that the action was timely, despite petitioner's argument to the contrary. (117 Fed. (2d), 133.) On April 14, 1941, we granted certiorari. (— U. S., —.)

Relying principally on *Bonwit-Teller & Co.* v. *United States* (283 U. S., 258), respondent maintains that its action was commenced well within the applicable period of limitation. Further, respondent contends that both courts below correctly refused to regard section 284(b)2 as a limitation on the Commissioner's duty to make refunds under section 284(g). We find it unnecessary to examine the latter contention, for we are of opinion that respondent sued too late.

In so far as material here, section 1113(a) provides: "* * * No [suit or proceeding for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected] shall be begun * * * after the expiration of five years from the date of the payment of such tax * * * unless such suit or proceeding is begun within two years after the disallowance of the part of such claim to which such suit or proceeding relates."

Undoubtedly, respondent has failed to begin its action within either of the periods specified in section 1113(a). (See *United States* v. *A. S. Kreider Co.*, 97 Fed. (2d), 387, 388.) The suit was not instituted until March 7, 1932, although the last tax payment was made on July 26, 1926, and the claim for refund was disallowed in October, 1929.[2] But as already stated, the court below

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[1] SEC. 284. (a) Where there has been an overpayment of any income, war-profits, or excess-profits tax imposed [by specified Acts], the amount of such overpayment shall [subject to enumerated conditions] be refunded immediately to the taxpayer.

(b) Except as provided in subdivisions * * * (g) of this section—

(1) No such credit or refund shall be allowed or made after * * * four years from the time the tax was paid in the case of a tax imposed by any prior Act, unless before the expiration of such period a claim therefor is filed by the taxpayer; and

(2) The amount of the credit or refund shall not exceed the portion of the tax paid during the * * * four years * * * immediately preceding the filing of the claim. * * *

(g) * * * If the taxpayer has, on or before June 15, 1926, filed such a waiver in respect of the taxes due for the taxable year 1920 or 1921, then such credit or refund relating to the taxes for the taxable year 1920 or 1921 shall be allowed or made if claim therefor is filed either on or before April 1, 1927, or within four years from the time the tax was paid. * * *

[2] It should be noted that this action seeks recovery of money which was paid in 1921. We assume, so far as this decision is concerned, that the phrase "such tax" in the quoted language refers to the total tax for the year in question whenever determined and assessed; or stated differently, that "payment" within the meaning of this statute does not occur until the entire tax for 1920 is paid, including deficiency assessments made several years later. Compare *Union Trust Co.* v. *United States* (70 Fed. (2d), 629).

We assume also that the Commissioner's refusal in 1929 to make the refund was a "disallowance" of respondent's claim. Compare *Bonwit-Teller & Co.* v. *United States* (283 U. S., 258, 265) with *United States* v. *Bertelsen & Petersen Engineering Co.* (306 U. S., 276, 280).

held that the action was not barred because the Tucker Act (24 Stat., 505), later incorporated in section 24(20) of the Judicial Code, rather than section 1113(a) prescribed the period within which respondent was bound to bring suit. We view the statutes differently.

Section 24(20) gives the district courts jurisdiction concurrent with the Court of Claims of certain suits against the United States. To equate the right thus conferred to the existing right to sue in the Court of Claims (see 28 U. S. C., section 262), the statute provides: "No suit against the Government of the United States shall be allowed under this paragraph unless the same shall have been brought within six years after the right accrued for which the claim is made."

We think the quoted language was intended merely to place an outside limit on the period within which all suits might be initiated under section 24(20). Clearly nothing in that language precludes the application of a different and shorter period of limitation to an individual class of actions even though they are brought under section 24(20). Phrasing the condition negatively, Congress left it open to provide less liberally for particular actions which, because of special considerations, required different treatment. (See *Christie-Street Commission Co.* v. *United States*, 136 Fed., 326, 332-333.)

Section 1113(a) is precisely that type of provision. Recognizing that suits against the United States for the recovery of taxes impeded effective administration of the revenue laws, Congress allowed only five years from payment of the tax for the commencement of such actions, unless specified circumstances extended the period. That this specific provision is entirely consistent with the general provision in section 24(20) is plain. Indeed, the limitation in section 1113(a) has no meaning whatever unless the limitation in section 24(20) is construed not to govern proceedings for the recovery of "internal-revenue tax alleged to have been erroneously or illegally assessed or collected."[3]

Bonwit-Teller & Co. v. *United States*, supra, does not remove the bar of section 1113(a) here. There we held under the peculiar facts disclosed that the taxpayer could evade the limitations of that section by grounding its action on a subsequent "account stated" rather than on the original, wrongful overassessment. But the instant case is plainly distinguishable, for, assuming that familiar doctrines of contracts furnish the test (*Daube* v. *United States*, 289 U. S., 367, 370), we are unable to find the requisites of an account stated in the transactions on which respondent relies.

To establish an account stated, respondent must show that a balance was struck "in such circumstances as to import a promise of payment on the one side and acceptance on the other." (*R. H. Stearns Co.* v. *United States*, 291 U. S., 54, 65; see also, *Toland* v. *Sprague*, 12 Pet., 300, 325; *Nutt* v. *United States*, 125 U. S., 650.) But plainly, "no such promise is a just or reasonable inference from the certificate of overassessment delivered to this taxpayer, if the certificate is interpreted in the setting of the occasion." (*R. H. Stearns Co.* v. *United States*, supra.) In fact, a contrary inference is the only legitimate supposition respondent could make. At most, respondent could assume that the United States promised to pay $1,362.50; the check was there in fulfillment. Obviously, refusal to refund the balance did not and could not imply a promise to pay the amount withheld.

Acceptance by respondent, another essential of an account stated, is equally lacking. By accepting the check for $1,362.50 respondent agreed only to a partial account stated (compare *Sturm* v. *Boker*, 150 U. S., 312, 340), thereby converting that much of the statement into an account settled. The institution of this suit is ample proof that respondent never intended to accept the certificate in its entirety as a correct computation of the amount which it claimed was due.

We conclude that respondent's suit is barred by the limitations of section 1113(a). The judgment is reversed, and the cause is remanded with directions to dismiss the petition.

It is so ordered.

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[3] Apparently the applicability of a specific limitation instead of the general Tucker Act limitation has not been challenged for 35 years. (See *Christie-Street Commission Co.* v. *United States*, 136 Fed. 326.) The specific limitation has been assumed to apply in numerous cases. (See, e. g., *United States* v. *Bertelsen & Petersen Engineering Co.*, 306 U. S., 276; *Bates Mfg. Co.* v. *United States*, 303 U. S., 567; *R. H. Stearns Co.* v. *United States*, 291 U. S., 54; *Daube* v. *United States*, 289 U. S., 367.)

ARTICLE 322–7: Limitations upon the crediting and refunding of taxes paid. 1941–24–10744 I. T. 3483

REVENUE ACT OF 1934.

Where Federal income tax deficiencies for the years 1934 and 1935 were paid on February 28, 1938, and claims for refund of the deficiencies and interest thereon were filed on February 29, 1940 (the year 1940 being a leap year), such claims were filed within the 2-year period of limitation prescribed by section 322(b)1 of the Revenue Act of 1934.

Advice is requested whether certain claims for refund filed on February 29, 1940, with respect to Federal income tax deficiencies for the years 1934 and 1935, were filed within the 2-year period of limitation prescribed by section 322(b)1 of the Revenue Act of 1934.

The income tax deficiencies for the years 1934 and 1935, as to which claims for refund were filed, were paid on February 28, 1938. Claims for the refund of these deficiencies and interest thereon were filed on February 29, 1940. In view of the fact that the year 1940 was a leap year, the issue involved is whether the extra day, February 29, 1940, should be regarded as "within two years from the time the tax was paid," as provided in section 322(b)1 of the Revenue Act of 1934, relating to the period of limitation on allowance of refunds and credits.

The United States Supreme Court in *Burnet* v. *Willingham Loan & Trust Co.* (282 U. S., 437, Ct. D. 292, C. B. X–1, 258 (1931)) enunciated the principle that in reckoning the period of limitation after the happening of an event (payment of the tax deficiencies on February 28, 1938, in the instant case), the day on which the event happened should be excluded from the computation. Accordingly, the 2-year period of limitation here involved did not begin to run until March 1, 1938.

The term "year," when used to designate the statutory period of limitation, means "calendar year" unless some other meaning is clearly indicated. "Calendar year" in turn means a 12-month period regardless of whether it contains 365 or 366 days. The intervention of February 29 during a leap year has been held not to change the day of the month for expiration of a period of limitation defined in terms of years. (*People* v. *Hill*, 2 Cal. App. (2d), 141, 37 P. (2d), 849; *Ex parte Johnson*, 53 Ariz., 161, 87 P. (2d), 107; *Rice et al.* v. *Blair*, 158 Ky., 680, 166 S. W., 180; *Douglas* v. *Acacia Mutual Life Insurance Co.*, Tex. Civ. App., 118 S. W. (2d), 643.) The 2-year period of limitation for filing claims after payment of the taxes in the instant case did not expire until March 1, 1940, or, in other words, the claims were required to be filed on or before the last day of February, 1940. Since the taxpayer's claims for refund covering the taxes in question for the years 1934 and 1935 were filed on February 29, 1940, such claims were filed within the 2-year period of limitation prescribed by section 322(b)1 of the Revenue Act of 1934.

EMPLOYMENT TAXES.

INTERNAL REVENUE CODE.

CHAPTER 9, SUBCHAPTER A.—FEDERAL INSURANCE CONTRIBUTIONS ACT.

SECTION 1426: Definitions. 1941–10–10630
REGULATIONS 106, SECTION 402.204: Who are employees. S. S. T. 411
(Also Subchapter C (Federal Unemployment Tax Act), Section 1607; Regulations 107, Section 403.204.)

Collectors performing services for the M Publishing Co. are employees of that company for purposes of the taxes imposed by Subchapters A and C, Chapter 9, of the Internal Revenue Code, as amended by the Social Security Act Amendments of 1939.

Advice is requested whether collectors performing services for the M Publishing Co. are employees of that company for purposes of the taxes imposed by Subchapters A and C, Chapter 9, of the Internal Revenue Code, as amended by the Social Security Act Amendments of 1939.

The M Publishing Co. (hereinafter called the company) is engaged in the business of publishing various periodicals and its representatives take orders for subscriptions. A large volume of subscriptions is sold on an installment contract basis, collections upon the installment subscription contracts being made by collectors at intervals agreed upon with the subscriber, usually monthly.

The contract between a collector and the company is on a standard form designated as a "collector's appointment," which provides that the individual shall file a bond; that he will collect only in the district assigned to him; that the company will pay a weekly commission varying in percentage in accordance with the number of days per week devoted to collection work; and that the collector shall submit a collection report for each day's work during the week. Provision is also made for payment of commissions on subscriptions secured by the collector. The company reserves the right to revoke the appointment at any time. The "collector's appointment" contains none of the details of the work to be performed, nor any of the responsibilities of the collector with respect thereto. It is apparent, therefore, that the written contract is not intended to embody all of the details of the relationship between the parties.

The details of the arrangements for the duties of particular collectors differ in various localities and are dependent upon the proximity of branch offices of the company, the population of the particular territory, and similar factors. Generally, it appears that the collectors are assigned to various districts and operate either directly or in-

directly from the company's branch offices. Each collector is given a number of subscription contracts to collect, which are arranged in routes for convenience in collecting. In rural areas an individual may have a more or less permanent route, but in metropolitan areas routes are assigned to different collectors at will. In some instances the subscription contracts are mailed to the collectors and remittances and reports are made by mail. In many cases, however, the collectors operate out of the branch offices, reporting at a specified time each morning for assignments of routes and for the receipt of contracts on which collections are to be made. Tardiness or failure to report results in reprimands and threatened dismissal. At the close of the day, or at specified intervals, the collectors report personally to the offices.

The collectors are required to collect a certain percentage on the contracts each month, failure to do so resulting in discharge. In many cases such collections require all of the collector's time. Collectors are discouraged and sometimes forbidden to engage in any other occupations, particularly collection work. The company mails out letters of instructions at regular intervals, the contents consisting of criticism of the collector's work, requests that specific tasks be performed, and instructions on incidental matters, such as verification of subscriptions and inspection of magazines, postal matters, etc. The company customarily requires the attendance of collectors at conferences for the purpose of group instruction. The collectors are responsible for calling upon those individuals whose contracts have expired in order to obtain renewal subscriptions. The collectors do not have drawing accounts to meet expenses nor are they furnished with means of transportation. In connection with their work the collectors are held out to the public as representatives of the company.

The present issue is whether or not the degree of control reflected in the foregoing facts is sufficient to establish the legal relationship of employer and employee.

Generally the relationship of "employer" and "employee" exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to *what* shall be done but *how* it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. Whether the relationship of employer and employee exists will in doubtful cases be determined upon an examination of the particular facts of each case. (Section 402.204, Regulations 106; section 403.204, Regulations 107.)

It is apparent from a consideration of the facts and the pertinent regulations that the M Publishing Co. has the right to and does exercise direction and control over the details and means by which the services of the collectors are performed. It is therefore held that the

collectors are employees of the M Publishing Co. for the purposes of Subchapters A and C, Chapter 9, of the Internal Revenue Code, as amended by the Social Security Act Amendments of 1939.

SECTION 1426: Definitions. 1941–11–10646
REGULATIONS 106, SECTION 402.204: Who are employees. S. S. T. 412
(Also Section 402.213; Subchapter C (Federal Unemployment Tax Act), Section 1607; Regulations 107, Sections 403.204 and 403.213.)

Individuals performing services for the M Company in the construction of a Federal project under a "cost-plus-a-fixed-fee" contract with the United States Navy Department are employees of that company for purposes of the taxes imposed by Subchapters A and C of Chapter 9 of the Internal Revenue Code, as amended by the Social Security Act Amendments of 1939.

Advice is requested whether individuals performing services for the M Company in the construction of a Federal project under a "cost-plus-a-fixed-fee" contract with the United States Navy Department are employees of that company for purposes of the taxes imposed by Subchapters A and C, Chapter 9, of the Internal Revenue Code, as amended by the Social Security Act Amendments of 1939.

The M Company (hereinafter called the company) is engaged in general construction and building activities and operates an independent business enterprise. It has agreed with the Navy Department to construct certain buildings at a naval training station. Under the terms of the contract, the company agrees to construct or otherwise accomplish the completion of the buildings; to furnish all plans and specifications which may be determined by the Navy Department to be necessary, such plans and specifications to be subject to the approval of the contracting officer of the Department; to provide all plant and equipment as may be required; and to furnish all services and labor, including personal services of every character, except such as may be furnished by the Government, and all materials and supplies required to complete the project. The Navy Department reserves the right to inspect materials and supplies, as well as the completed work, and, through the contracting officer, may make changes in approved drawings and/or specifications. Where such change results in a material increase or decrease in the work to be done by the company, or the time required for its performance, an equitable adjustment of the fixed fee to be paid to the company is to be made and the original contract is to be modified in writing accordingly. Furthermore, the Department may terminate the contract at any time upon the refusal, neglect, or failure of the company to prosecute the work with promptness and diligence. The company agrees to keep accurate records and books of account showing the costs of all items of labor, materials, equipment, supplies, services, and charges incurred in completing the work.

The Navy officer in charge may attend meetings of the board of directors of the company to secure information relative to any matter within the purview of the contract. No person may be assigned by the company to certain enumerated positions carrying supervisory

powers until there is submitted to the contracting officer a statement of the qualifications and experience of the individual proposed for such assignment and such assignment is approved by the contracting officer.

The Government agrees to pay to the company the actual net cost of the materials furnished and of the services performed in the completion of the project and a fee of $500x$ dollars. The contract, in specifying the items which may be a part of the actual cost, lists the net amount of any State or local taxes, fees, or charges, which the company may be required to pay on or for any plant, equipment, process, organization, materials, or personnel under any applicable valid law or regulations issued by competent authority. Payment to the company is by Government check payable upon receipt of requisitions accompanied by certified and approved pay rolls, invoices, bills, or other substantiating documents and issuance of vouchers to be signed by the company.

It is apparent from the terms of the contract that the Navy Department has contracted for the accomplishment of a particular job, and that the M Company, which is engaged in general construction and building activities, is acting as an independent contractor with respect to the project here involved. It is therefore held that the individuals in question are employees of the M Company for the purposes of Subchapters A and C, Chapter 9, of the Internal Revenue Code, as amended by the Social Security Act Amendments of 1939. (See generally S. S. T. 320, C. B. 1938–2, 321, and the rulings cited therein.)

SECTION 1426: Definitions. 1941–22–10726
REGULATIONS 106, SECTION 402.204: Who are employees. S. S. T. 416
(Also Subchapter C (Federal Unemployment Tax Act), Section 1607; Regulations 107, Section 403.204.)

> Men engaged by the M Coal Co. to store coal delivered to customers are employees of that company for purposes of the taxes imposed by Subchapters A and C, Chapter 9, of the Internal Revenue Code, as amended by the Social Security Act Amendments of 1939.

Advice is requested whether men engaged by the M Coal Co. to store coal delivered to customers are employees of that company for Federal employment tax purposes.

The M Coal Co. is engaged in the retail distribution of coal. When a customer submits an order, he is requested to indicate whether he desires that a man be sent with the delivery to effect a transfer of the coal from the curb to the customer's bin. If the customer desires this service, he is advised that he will be required to pay for the necessary labor at the rate of x cents per ton, and is requested to sign a statement authorizing the company to charge such amount to his account.

Each morning it is customary for a number of men to congregate at the company's yards for work. When an order is received by the company, the man selected to store the coal is presented with a slip for the customer to sign upon completion of the work, and is transported by company truck to the customer's premises. After the coal is dumped at the curb, the man sent by the company stores

the coal in the customer's bin and returns to the coal yard with the customer's signed statement, where he is paid in cash. The company pays the cost of the coal storer's transportation back to the coal yard and also the cost of any telephone calls made to the yard. In case the coal storer does not own a shovel and bucket to be used in storing the coal, they are furnished by the company. Where a cash customer fails to pay the coal storer, or fails to sign a statement authorizing payment by the company at such customer's expense, the company nevertheless pays the storer the amount agreed upon.

On the basis of the facts presented, it is the opinion of the Bureau that the men engaged by the M Coal Co. to store coal delivered to customers are employees of that company for purposes of the taxes imposed by Subchapters A and C, Chapter 9, of the Internal Revenue Code, as amended by the Social Security Act Amendments of 1939.

SECTION 1426: Definitions.
REGULATIONS 106, SECTION 402.205: Who are employers.

Status of lessee of one of the departments in the N Department Store. S. S. T. 20 (C. B. XV–2, 402) revoked. (See S. S. T. 409, page 415.)

SECTION 1426: Definitions. 1941–9–10621
REGULATIONS 106, SECTION 402.205: Who are employers. S. S. T. 410

(Also Subchapter C (Federal Unemployment Tax Act), Section 1607; Regulations 107, Section 403.205; and Social Security Act, Section 907; Regulations 90, Article 204.)

Services performed by a father-in-law in the employ of his son-in-law in the community property State of Texas are not excepted from "employment" by sections 1426(b)4 and 1607(c)5 of the Internal Revenue Code, as amended.
S. S. T. 256 (C. B. 1938–1, 425) revoked.

The question is presented whether services performed by a father-in-law in the employ of his son-in-law in the community property State of Texas are excepted from "employment" for Federal employment tax purposes.

Sections 1426(b)4 and 1607(c)5, Subchapters A and C, respectively, of Chapter 9 of the Internal Revenue Code, as amended by the Social Security Act Amendments of 1939, except from "employment":

Service performed by an individual in the employ of his son, daughter, or spouse, and service performed by a child under the age of 21 in the employ of his father or mother * * *.

In S. S. T. 256 (C. B. 1938–1, 425) it was held that for the purpose of Titles VIII and IX of the Social Security Act a husband and wife domiciled in the State of Texas are deemed to be the joint employers of all individuals employed by each in the production of community income. It is urged that an application of S. S. T. 256 in the instant case should result in the conclusion that the services of the father-in-law are performed in the employ of his daughter as well as in the

employ of his son-in-law and, consequently, that the "family employment" exception quoted above should apply.

Generally, questions as to the identity of an employer or as to whether an employment relationship exists are resolved by ascertaining whether the person performing the services is subject to the direction and control of the person for whom the services are performed. (Article 205, Regulations 90; article 3, Regulations 91; section 402.204, Regulations 106; section 403.204, Regulations 107.) Under the community property law in force in the State of Texas, both the husband and the wife during coverture may be possessed of separate property, both real and personal, each having the sole management, control, and disposition of such separate property. However, all property acquired by either the husband or wife during marriage, other than separate property, is deemed to be the community property of the husband and wife. By statute the husband has the sole right during marriage to dispose of the community property and to manage and control it. The wife's separate property is not liable for the debts incurred by the husband in the management of the community property.

On the basis of the Texas law pertaining to the rights of the husband in his separate and community property, it is held that for Federal employment tax purposes the husband is the sole employer of the employees engaged by him in connection with his separate property and in connection with the community property managed by him. It is likewise held that the employees engaged by the wife in the management of her separate property are her employees. Inasmuch as the conclusions reached are contrary to S. S. T. 256, supra, that ruling is revoked.

In the light of the foregoing, it is the opinion of this office that as the husband alone is charged with the management of the community property and the wife's separate estate is not liable for debts incurred by the husband in the management of the community property, services performed by the wife's father in connection with a community business managed by the husband do not come within the "family employment" exception. Liability for the Federal employment taxes is, therefore, incurred with respect to the wages for such services.

SECTION 1426: Definitions. 1941-23-10734
REGULATIONS 106, SECTION 402.208: Agricultural labor. S. S. T. 417
(Also Subchapter C (Federal Unemployment Tax Act), Section 1607; Regulations 107, Section 403.208.)

> Services performed by employees of the M Water Co. in connection with the operation or maintenance of its ditches, canals, reservoirs, or waterways, which are used partly or wholly for supplying or storing water for both domestic and farming purposes, are not excepted from "employment" as "agricultural labor" for purposes of Subchapters A and C, Chapter 9, of the Internal Revenue Code, as amended by the Social Security Act Amendments of 1939.

The question is presented whether services performed by employees of the M Water Co. rendered in connection with the operation and maintenance of its ditches, canals, reservoirs, or waterways

used for supplying or storing water for both domestic and farming purposes constitute "agricultural labor" for employment tax purposes.

The M Water Co. is a nonprofit, mutual corporation whose facilities are used for furnishing water to stockholder-farmer members primarily for irrigation purposes. In some instances the company supplies water for domestic use, such water being pumped by an automatic pumping plant. Meters installed for such purpose gauge the amounts of water so pumped in order that a special charge may be made therefor. Some of the members purchase water from the corporation for domestic use only and receive their irrigation water supply from other sources.

Section 1426(h) of Subchapter A, Chapter 9, of the Internal Revenue Code, provides in part as follows:

AGRICULTURAL LABOR.—The term "agricultural labor" includes all services performed—

* * * * * * *

(3) * * * in connection with the operation or maintenance of ditches, canals, reservoirs, or waterways used exclusively for supplying and storing water for farming purposes.

Section 1607(1) of Subchapter C, Chapter 9, of the Internal Revenue Code, as amended, contains identical provisions.

It is the opinion of the Bureau that the services contemplated by the above-quoted provisions of section 1426(h)3 and the corresponding provisions of section 1607(l)3 of the Code, as amended, include only those services performed in connection with the operation and maintenance of facilities which are used solely and exclusively for the supplying and storing of water for farming purposes. There is nothing in the wording of the statute to support an inference that the term "farming purposes" was intended to include within its meaning the term "domestic purposes." It is clear that the M Water Co. has made special provisions for its "domestic consumers," and that it is not the intent of the company that the water it supplies be used solely for farming purposes.

Upon the basis of the facts presented and in view of the foregoing provisions of law, it is held that services performed by employees of the M Water Co. in connection with the operation or maintenance of its ditches, canals, reservoirs, or waterways, which are used partly or wholly for supplying or storing water for domestic purposes, are not excepted from "employment" as "agricultural labor" for purposes of Subchapters A and C, Chapter 9, of the Internal Revenue Code, as amended. However, if any ditches, canals, etc., operated by the company are used exclusively for supplying or storing water for farming purposes, services performed by employees of the company in connection with the operation or maintenance thereof constitute "agricultural labor" for purposes of the above-mentioned provisions of law.

SECTION 1426: Definitions.
REGULATIONS 106, SECTION 402.208: Agricultural labor.

Processing, grading, and baling of cigar leaf wrapper tobacco. S. S. T. 382 (C. B. 1940–1, 218) revoked, and S. S. T. 219 (C. B. 1937–2, 412) reinstated. (See S. S. T. 418, page 416.)

SECTION 1426: Definitions.
REGULATIONS 106, SECTION 402.213: United States and instrumentalities thereof.

Individuals performing services for the M Company in the construction of a Federal project. (See S. S. T. 412, page 400.)

SECTION 1426: Definitions. 1941-21-10723
REGULATIONS 106, SECTION 402.214: States and their political subdivisions and instrumentalities. S. S. T. 415

A, in performing services as attorney in the collection of delinquent taxes, is not an officer or an employee of the State of Tennessee or a political subdivision thereof within the meaning of section 1426(b)7, Subchapter A, Chapter 9, of the Internal Revenue Code, as amended by the Social Security Act Amendments of 1939.

Advice is requested whether services performed by A as attorney of Y County in the State of Tennessee in the collection of delinquent taxes are excepted from "employment" under section 1426(b)7, Subchapter A, Chapter 9, of the Internal Revenue Code, as amended by the Social Security Act Amendments of 1939.

Section 1588 of the Code of Tennessee provides that after the publication of notice to delinquent taxpayers, and between the dates of February 1 and March 1, the county trustee shall deliver the delinquent lists showing all unpaid land taxes to an attorney chosen by him with the approval of the county judge, or chairman of the county court; that it shall be the duty of the county trustee and the county judge, or chairman, to cause such attorney to prepare and file suits in the chancery or circuit court for the collection of all delinquent land taxes and all arrears of taxes due the State, county, and municipality; and that it shall be the duty of the proper municipal officers to furnish the county trustee or his attorney certified lists of delinquent taxes, unless otherwise provided. Section 1590 of the code, as amended, provides that upon the filing of suits to enforce the tax lien, an additional penalty of 5 per cent upon all delinquent land taxes shall accrue and is imposed upon the amount due from any defendant to the State, county, or municipality, which penalty shall be devoted to the expense of prosecuting the suits and shall be allowed to the attorney filing the suits as compensation for his services. Section 1591 of the code, as amended, provides in part that the attorney designated by the trustee with the approval of the county judge shall, after February 1 and not later than March 1, file suits in the circuit or chancery court of the county for the collection of delinquent land taxes due the State, county, and municipality, as well as the interest, penalties, and costs attached to and a part of such taxes, which taxes, interest, penalties, and costs are declared a lien upon the land. For the enforcement of this lien, the suits shall be brought in the name of the State, in its own behalf, and for the use and benefit of the county and of any municipality certifying the lists of delinquent taxes.

A's appointment as attorney for the collection of delinquent taxes was made orally by the county trustee of Y County and approved orally by the county judge. The terms and conditions of his employment are in accordance with the provisions of the Code of Tennessee.

At the time of his appointment A did not take an oath of office nor was he required to give a bond for the faithful performance of his duties. In connection with his duties, it is necessary for A to appear in court, confer with taxpayers, send out letters requesting payment of taxes, and make quarterly reports to the auditor of Y County of the collections made through his office. A is allowed to conduct the suits filed by him without any detailed direction from officials of the State or a political subdivision thereof. The Tennessee statutes require the attorney collecting delinquent taxes to file suit against every delinquent taxpayer certified to him, but after suit is filed, its conduct is within the attorney's discretion, except that under section 1607 of the Tennessee Code, compromise of delinquent taxes is not within the attorney's power but is left to the commissioner of finance and taxation with the approval of the governor and attorney general.

A's office as attorney for the collection of delinquent taxes is in the Y County Public Building and Court House. This office, together with the furniture and fixtures and the books containing the names of delinquent taxpayers, is furnished by the county. All other office expenses, including the salary of one clerk, are borne by A. He fixes the amount of the clerk's compensation and determines his duties. A is also engaged in the general practice of law and maintains an office at his own expense for such purpose.

Section 1426(b)7 of Subchapter A of Chapter 9 of the Internal Revenue Code, as amended, provides in part:

> The term "employment" means any service * * * except—
> * * * * * * *
> (7) Service performed in the employ of a State, or any political subdivision thereof, or any instrumentality of any one or more of the foregoing which is wholly owned by one or more States or political subdivisions; and any service performed in the employ of any instrumentality of one or more States or political subdivisions to the extent that the instrumentality is, with respect to such service, immune under the Constitution of the United States from the tax imposed by section 1410; * * *

On the basis of the presented facts, it is held that A is not an officer or an employee of the State of Tennessee or a political subdivision thereof for the purpose of the exception from "employment" contained in section 1426(b)7, Subchapter A, Chapter 9, of the Internal Revenue Code, as amended.

REGULATIONS 106, SECTION 402.216: Railroad industry—employees and employee representatives under Section 1532 of the Internal Revenue Code. 1941-1-10552 T. D. 5030

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PART 402.

Regulations 106 amended to conform to certain provisions of the Joint Resolution approved June 11, 1940, the Act approved August 13, 1940, and the Act approved October 10, 1940.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

In order to conform Regulations 106 [Part 402, Title 26, Code of Federal Regulations, 1940 Sup.], relating to the employees' tax and

the employers' tax under the Federal Insurance Contributions Act (53 Stat., 175, 1381; 26 U. S. C., Sup. V, 1400 to 1432, inclusive), to section 3 of the Joint Resolution approved June 11, 1940 (Public Resolution No. 81, Seventy-sixth Congress, third session), sections 1, 3, 4, and 6 of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, third session), and section 27 of the Act approved October 10, 1940 (Public, No. 833, Seventy-sixth Congress, third session), such regulations are amended by inserting immediately preceding section 402.216 thereof the following:

Section 3 of the Joint Resolution approved June 11, 1940 (Public Resolution No. 81, Seventy-sixth Congress, Third Session).

Subsection (b) of section 1532 of the Internal Revenue Code, approved February 10, 1939 (53 Stat. 1), is hereby amended by substituting for the second proviso therein the following: "*Provided, however*, That an individual shall not be deemed to be in the employment relation to a carrier unless during the last pay-roll period in which he rendered service to it he was with respect to that service in the service of an employer in accordance with subsection (d) of this section."

Subsection (d) of section 1532 of said Code is hereby amended by changing the period at the end thereof to a colon and adding the following: "*Provided further*, That an individual not a citizen or resident of the United States shall not be deemed to be in the service of an employer when rendering service outside the United States to an employer who is required under the laws applicable in the place where the service is rendered to employ therein, in whole or in part, citizens or residents thereof; and the laws applicable on August 29, 1935, in the place where the service is rendered shall be deemed to have been applicable there at all times prior to that date."

The amendments in this section shall operate in the same manner and have the same effect as if they had been part of the Internal Revenue Code when that Code was enacted on February 10, 1939 * * *.

Sections 1, 3, 4, and 6 of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, Third Session).

That * * * section 1532(a) of the Internal Revenue Code * * * are amended, effective * * * as of the date of its enactment, by adding at the end of * * * such section the following new sentence: "The term 'employer' shall not include any company by reason of its being engaged in the mining of coal, the supplying of coal to an employer where delivery is not beyond the mine tipple, and the operation of equipment or facilities therefor, or in any of such activities."

SEC. 3. * * * section 1532(b) of the Internal Revenue Code * * * are amended, * * * as of the date of its enactment, by adding at the end of * * * such section * * * the following new paragraph:

"The term 'employee' shall not include any individual while such individual is engaged in the physical operations consisting of the mining of coal, the preparation of coal, the handling (other than movement by rail with standard railroad locomotives) of coal not beyond the mine tipple, or the loading of coal at the tipple."

SEC. 4. (a) The laws hereby expressly amended * * * shall operate as if each amendment herein contained had been enacted as a part of the law it amends, at the time of the original enactment of such law.

* * * * * * *

SEC. 6. Nothing contained in this Act, nor the action of Congress in adopting it, shall be taken or considered as affecting the question of what carriers, companies, or individuals, other than those in this Act specifically provided for, are included in or excluded from the provisions of the various laws to which this Act is an amendment.

Section 27(a) of the Act approved October 10, 1940 (Public, No. 833, Seventy-sixth Congress, Third Session).

Subsection (e) of section 1532 of the Internal Revenue Code is amended by adding thereto the following sentence: "For the purpose of determining the amount of taxes under sections 1500 and 1520, compensation earned in the service of a local lodge or division of a railway-labor-organization employer shall be disregarded with respect to any calendar month if the amount thereof is less than $3 and (1) such compensation is earned before April 1, 1940, and the taxes thereon under such sections are not paid before July 1, 1940, or (2) such compensation is earned after March 31, 1940."

(This Treasury decision is issued under the authority contained in sections 1429 and 3791 of the Internal Revenue Code (53 Stat., 178, 467; 26 U. S. C., Sup. V, 1429, 3791), section 3 of the Joint Resolution approved June 11, 1940 (Public Resolution No. 81, Seventy-sixth Congress, third session), sections 1, 3, 4, and 6 of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, third session), and section 27 of the Act approved October 10, 1940 (Public, No. 833, Seventy-sixth Congress, third session).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved December 27, 1940.

HERBERT E. GASTON,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register December 30, 1940, 10.57 a. m.)

SECTION 1426: Definitions. 1941–15–10680
REGULATIONS 106, SECTION 402.227: Wages. S. S. T. 413
(Also Subchapter C (Federal Unemployment Tax Act), Section 1607; Regulations 107, Section 403.227.)

Transportation allowances paid to employees of the M Company while working on a Federal project constitute "wages" for purposes of Subchapters A and C, Chapter 9, of the Internal Revenue Code, as amended by the Social Security Act Amendments of 1939.

The question is presented whether amounts paid to employees of the M Company as transportation allowances while working on a Federal project constitute "wages" for employment tax purposes.

It is the practice of the M Company to make allowances to employees to cover the expense of transportation to and from Federal projects where sufficient skilled labor is not available in the immediate vicinity. An agreement between representatives of the Government and certain labor unions authorizes the payment of such allowances, as follows:

The transportation reimbursement to the contractor shall be in a flat amount for all trades concerned at *x* cents per day per man, and the workmen shall be reimbursed for this transportation in checks entirely separate from the pay roll.

Subject to limitations not here applicable, the term "wages" is defined in sections 1426(a) and 1607(b) of Subchapters A and C, Chapter 9, of the Internal Revenue Code, as amended, to mean "all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash." Section

402.227(b)2 of Regulations 106, issued pursuant to Subchapter A, Chapter 9, of the Code, as amended, provides, under the heading "Traveling expenses," that "amounts paid to traveling salesmen or other employees as allowance or reimbursement for traveling or other expenses incurred in the business of the employer constitute wages only to the extent of the excess of such amounts over such expenses actually incurred and accounted for by the employee to the employer." Section 403.227(b)2 of Regulations 107, issued pursuant to Subchapter C, Chapter 9, of the Code, as amended, contains identical provisions.

The amounts expended by the employees of the M Company for transportation to and from the project in question may not be considered as "traveling expenses" within the meaning of that term as used in Regulations 106 and 107, since that term relates only to expenses incurred by the employee in the business of the employer. In the instant case, any amounts expended by the employees for transportation to and from the project do not represent expenses incurred in the business of the employer but represent personal expenses incurred by the employees. (See S. M. 1048, C. B. 1, 101 (1919); *Appeal of Frank H. Sullivan*, 1 B. T. A., 93.) Accordingly, it is held that the transportation allowances paid to the employees of the M Company constitute "wages" for purposes of Subchapters A and C, Chapter 9, of the Internal Revenue Code, as amended by the Social Security Act Amendments of 1939.

CHAPTER 9, SUBCHAPTER B.—EMPLOYMENT BY CARRIERS.

REGULATIONS 100. 1941–1–10553
(Also Carriers Taxing Act of 1937.) T. D. 5029

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PART 410.

Regulations 100, and such regulations as made applicable to the Internal Revenue Code by Treasury Decision 4885 [C. B. 1939–1 (Part 1), 396], amended.

Exemption from taxation under the Carriers Taxing Act of 1937 and Subchapter B of Chapter 9 of the Internal Revenue Code of certain compensation earned in the service of a local lodge or division of a railway labor organization employer.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

In order to conform Regulations 100 [Part 410, Title 26, Code of Federal Regulations], relating to the employers' tax, employees' tax, and employee representatives' tax under the Carriers Taxing Act of 1937 (50 Stat., 435; 45 U. S. C., Sup. V, 261 to 273, inclusive), and such regulations as made applicable to the Internal Revenue Code (53 Stat., Part 1; 26 U. S. C., Sup. V) by Treasury Decision 4885 [C. B. 1939–1 (Part 1), 396] [Chapter I, note, Title 26, Code of Federal Regulations, 1939 Sup.], to section 27 of the Act

approved October 10, 1940 (Public, No. 833, Seventy-sixth Congress, third session), each of such regulations is amended as follows:

(1) Immediately preceding article 1 [section 410.1, Title 26, Code of Federal Regulations], the following is inserted:

Sections 1 and 27 of the Act approved October 10, 1940 (Public, No. 833, Seventy-sixth Congress, Third Session).

That * * * sections * * * 27 shall be effective as of July 1, 1940 * * *

SEC. 27. (a) Subsection (e) of section 1532 of the Internal Revenue Code is amended by adding thereto the following sentence: "For the purpose of determining the amount of taxes under sections 1500 and 1520, compensation earned in the service of a local lodge or division of a railway-labor-organization employer shall be disregarded with respect to any calendar month if the amount thereof is less than $3 and (1) such compensation is earned before April 1, 1940, and the taxes thereon under such sections are not paid before July 1, 1940, or (2) such compensation is earned after March 31, 1940."

(b) For the purpose of determining the amount of taxes under sections 2(a) and 3(a) of the Carriers Taxing Act of 1937, compensation earned in the service of a local lodge or division of a railway-labor-organization employer shall be disregarded with respect to any calendar month if the amount thereof is less than $3 and the taxes thereon under such sections are not paid before July 1, 1940.

(2) Immediately following the provisions of law under the caption "Section 1(e) of the Act" preceding article 5 [section 410.5, Title 26, Code of Federal Regulations], the following is inserted:

Section 27 of the Act approved October 10, 1940 (Public, No. 833, Seventy-sixth Congress, Third Session).

(a) Subsection (e) of section 1532 of the Internal Revenue Code is amended by adding thereto the following sentence: "For the purpose of determining the amount of taxes under sections 1500 and 1520, compensation earned in the service of a local lodge or division of a railway-labor-organization employer shall be disregarded with respect to any calendar month if the amount thereof is less than $3 and (1) such compensation is earned before April 1, 1940, and the taxes thereon under such sections are not paid before July 1, 1940, or (2) such compensation is earned after March 31, 1940."

(b) For the purpose of determining the amount of taxes under sections 2(a) and 3(a) of the Carriers Taxing Act of 1937, compensation earned in the service of a local lodge or division of a railway-labor-organization employer shall be disrgarded with respect to any calendar month if the amount thereof is less than $3 and the taxes thereon under such sections are not paid before July 1, 1940.

(3) Article 5 [section 410.5, Title 26, Code of Federal Regulations] is amended by striking out the parenthetical cross reference at the end of such article and inserting in lieu thereof the following:

(See article 7 [section 410.7, Title 26, Code of Federal Regulations], relating to when compensation is earned. See also article 201 [section 410.201 of such Title 26, 1940 Sup.], article 301 [section 410.301 of such Title 26, and 1940 Sup.], and article 401 [section 410.401 of such Title 26], relating to the amount of compensation included for the purpose of determining the employees' tax, the employers' tax, and the employee representatives' tax, respectively.)

(4) Immediately preceding article 201 [section 410.201, Title 26, Code of Federal Regulations], the following is inserted:

Section 27 of the Act approved October 10, 1940 (Public, No. 833, Seventy-sixth Congress, Third Session).

(a) * * * For the purpose of determining the amount of taxes under sections 1500 * * * [of the Internal Revenue Code], compen-

sation earned in the service of a local lodge or division of a railway-labor-organization employer shall be disregarded with respect to any calendar month if the amount thereof is less than $3 and (1) such compensation is earned before April 1, 1940, and the taxes thereon under such sections are not paid before July 1, 1940, or (2) such compensation is earned after March 31, 1940.

(b) For the purpose of determining the amount of taxes under sections 2(a) * * * of the Carriers Taxing Act of 1937, compensation earned in the service of a local lodge or division of a railway-labor-organization employer shall be disregarded with respect to any calendar month if the amount thereof is less than $3 and the taxes thereon under such sections are not paid before July 1, 1940.

(5) Article 201 [section 410.201, Title 26, Code of Federal Regulations] is amended to read as follows:

ART. 201 [Sec. 410.201, Title 26, Code of Federal Regulations, 1940 Sup.]. *Measure of employees' tax.*—(*a*) Except as provided in paragraph (*b*) of this article, the employees' tax is measured by the amount of compensation earned by an individual as an employee for services rendered to one or more employers on and after January 1, 1937, excluding, however, the amount of such compensation in excess of $300 which is earned by the employee for services performed during any one calendar month. (For provisions relating to compensation, see article 5 [section 410.5, Title 26, Code of Federal Regulations, and 1940 Sup.] and articles 6 and 7 [sections 410.6 and 410.7 of such Title 26].)

(*b*) If the amount of compensation earned in any calendar month by an individual as an employee in the service of a local lodge or division of a railway-labor-organization employer is less than $3, such amount shall be disregarded for the purpose of determining the employees' tax, provided:

(1) such compensation is earned before April 1, 1940, and the taxes thereon are not paid to the collector before July 1, 1940, or

(2) such compensation is earned after March 31, 1940.

(6) Immediately preceding article 301 [section 410.301, Title 26, Code of Federal Regulations], the following is inserted:

Section 27 of the Act approved October 10, 1940 (Public, No. 833, Seventy-sixth Congress, Third Session).

(a) * * * For the purpose of determining the amount of taxes under sections * * * 1520 [of the Internal Revenue Code], compensation earned in the service of a local lodge or division of a railway-labor-organization employer shall be disregarded with respect to any calendar month if the amount thereof is less than $3 and (1) such compensation is earned before April 1, 1940, and the taxes thereon under such sections are not paid before July 1, 1940, or (2) such compensation is earned after March 31, 1940.

(b) For the purpose of determining the amount of taxes under sections * * * 3(a) of the Carriers Taxing Act of 1937, compensation earned in the service of a local lodge or division of a railway-labor-organization employer shall be disregarded with respect to any calendar month if the amount thereof is less than $3 and the taxes thereon under such sections are not paid before July 1, 1940.

(7) Article 301 [section 410.301, Title 26, Code of Federal Regulations] is amended by adding at the end thereof the following new paragraph:

If the amount of compensation earned in any calendar month by an individual as an employee in the service of a local lodge or division of a railway-labor-organization employer is less than $3, such amount shall be disregarded for the purpose of determining the employers' tax, provided:

(1) such compensation is earned before April 1, 1940, and the taxes thereon are not paid to the collector before July 1, 1940, or

(2) such compensation is earned after March 31, 1940.

(This Treasury decision is issued under the authority contained in section 12 of the Carriers Taxing Act of 1937 (50 Stat., 440; 45 U. S. C.,

Sup. V, 272), sections 1535 and 3791 of the Internal Revenue Code (53 Stat., 183, 467; 26 U. S. C., Sup. V, 1535, 3791), and section 27 of the Act approved October 10, 1940 (Public, No. 833, Seventy-sixth Congress, third session).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved December 27, 1940.

HERBERT E. GASTON,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register December 30, 1940, 10.57 a. m.)

CHAPTER 9, SUBCHAPTER C.—FEDERAL UNEMPLOYMENT TAX ACT.

SECTION 1607: Definitions.
REGULATIONS 107, SECTION 403.204: Who are employees.

Collectors performing services for the M Publishing Co. (See S. S. T. 411, page 398.)

SECTION 1607: Definitions.
REGULATIONS 107, SECTION 403.204: Who are employees.

Individuals performing services for the M Company in the construction of a Federal project. (See S. S. T. 412, page 400.)

SECTION 1607: Definitions.
REGULATIONS 107, SECTION 403.204: Who are employees.

Men engaged in storing coal. (See S. S. T. 416, page 401.)

SECTION 1607: Definitions.
REGULATIONS 107, SECTION 403.205: Who are employers.

Status of lessee of one of the departments in the N Department Store. S. S. T. 20 (C. B. XV–2, 402) revoked. (See S. S. T. 409, page 415.)

SECTION 1607: Definitions.
REGULATIONS 107, SECTION 403.205: Who are employers.

"Family employment" in the community property State of Texas. S. S. T. 256 (C. B. 1938–1, 425) revoked. (See S. S. T. 410, page 402.)

SECTION 1607: Definitions. 1941–17–10695
REGULATIONS 107, SECTION 403.205: Who are employers. S. S. T. 414

Meaning of the term "calendar week" as used in section 1607(a), Subchapter C, Chapter 9, of the Internal Revenue Code, as amended.

Advice is requested as to the meaning of the term "calendar week" in section 1607(a) of the Internal Revenue Code, as amended by section 614 of the Social Security Act Amendments of 1939. In

the inquiry presented, the taxpayer states that his pay roll period begins on Saturday and ends on the following Friday.

Section 1607(a) of the Code, as amended, provides as follows:

> The term "employer" does not include any person unless on each of some 20 days during the taxable year, each day being in a different calendar week, the total number of individuals who were employed by him in employment for some portion of the day (whether or not at the same moment of time) was 8 or more.

The term "calendar week" in section 1607(a) of the Code, as amended, means a period of seven successive days beginning with Sunday and ending at the close of the following Saturday. The beginning and ending of the employer's weekly pay roll period are immaterial.

For the purpose of section 1607(a) of the Code, as amended, a day during a taxable (calendar) year is in a separate "calendar week," even if such calendar week does not fall wholly within the calendar year.

SECTION 1607: Definitions.
REGULATIONS 107, SECTION 403.208: Agricultural labor.

Services performed by employees of the M Water Co. in the maintenance of its facilities used partly or wholly for supplying or storing water for domestic purposes. (See S. S. T. 417, page 403.)

SECTION 1607: Definitions.
REGULATIONS 107, SECTION 403.208: Agricultural labor.

Processing, grading, and baling of cigar leaf wrapper tobacco. S. S. T. 382 (C. B. 1940–1, 218) revoked, and S. S. T. 219 (C. B. 1937–2, 412) reinstated. (See S. S. T. 418, page 416.)

SECTION 1607: Definitions.
REGULATIONS 107, SECTION 403.213: United States and instrumentalities thereof.

Individuals performing services for the M Company in the construction of a Federal project. (See S. S. T. 412, page 400.)

REGULATIONS 107 (as amended), SECTION 403.216: Railroad industry—employees and employee representatives under the Railroad Unemployment Insurance Act.

1941–1–10554
T. D. 5031

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PART 403.

Regulations 107 amended to conform to certain provisions of the Act approved August 13, 1940.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

In order to conform Regulations 107 [Part 403, Title 26, Code of Federal Regulations, 1940 Sup.], relating to the excise tax on em-

ployers under the Federal Unemployment Tax Act (53 Stat., 183, 1387; 26 U. S. C., Sup. V, 1600 to 1611, inclusive), to sections 1, 3, 4, and 6 of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, third session), such regulations are amended by inserting immediately preceding section 403.216 thereof the following:

Sections 1, 3, 4, and 6 of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, Third Session).

That * * * section 1(a) of the Railroad Unemployment Insurance Act are amended, effective * * * as of the date of its enactment, by adding at the end of * * * such section the following new sentence:

"The term 'employer' shall not include any company by reason of its being engaged in the mining of coal, the supplying of coal to an employer where delivery is not beyond the mine tipple, and the operation of equipment or facilities therefor, or in any of such activities."

SEC. 3. * * * section 1(d) of the Railroad Unemployment Insurance Act * * * are amended, * * * as of the date of its enactment, by adding at the end of * * * such section * * * the following new paragraph:

"The term 'employee' shall not include any individual while such individual is engaged in the physical operations consisting of the mining of coal, the preparation of coal, the handling (other than movement by rail with standard railroad locomotives) of coal not beyond the mine tipple, or the loading of coal at the tipple."

SEC. 4. (a) The laws hereby expressly amended * * * shall operate as if each amendment herein contained had been enacted as a part of the law it amends, at the time of the original enactment of such law.

* * * * * * *

SEC. 6. Nothing contained in this Act, nor the action of Congress in adopting it, shall be taken or considered as affecting the question of what carriers, companies, or individuals, other than those in this Act specifically provided for, are included in or excluded from the provisions of the various laws to which this Act is an amendment.

(This Treasury decision is issued under the authority contained in sections 1609 and 3791 of the Internal Revenue Code (53 Stat., 188, 467; 26 U. S. C., Sup. V, 1609, 3791), and sections 1, 3, 4, and 6 of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, third session).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved December 27, 1940.

HERBERT E. GASTON,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register December 30, 1940, 10.58 a. m.)

SECTION 1607: Definitions.
REGULATIONS 107, SECTION 403.227: Wages.

Transportation allowances paid to employees of the M Company. (See S. S. T. 413, page 408.)

TAXES UNDER SOCIAL SECURITY ACT.

SECTIONS 811 AND 907: Definitions. 1941-8-10613
REGULATIONS 91 AND 90, ARTICLES 4 AND 204: Who are employers. S. S. T. 409
(Also Internal Revenue Code, Chapter 9, Subchapter A (Federal Insurance Contributions Act), Section 1426; Regulations 106, Section 402.205; and Subchapter C (Federal Unemployment Tax Act), Section 1607; Regulations 107, Section 403.205.)

The N Department Store is the employer for social security and employment tax purposes of the employees in a department leased by it to the M Company. S. S. T. 20 (C. B. XV-2, 402 (1936)) revoked.

In S. S. T. 20 (C. B. XV-2, 402 (1936)) it was held that the M Company, the lessee of one of the departments in the N Department Store, was the "employer" of the employees in such department and was subject to the tax imposed by section 901, Title IX of the Social Security Act. The following facts appear in S. S. T. 20:

Under the terms of an agreement between the M Company and the N Department Store, the M Company leases space within the N Department Store for the purpose of operating a certain department. In consideration thereof the M Company pays a percentage of its sales to the N Department Store. Generally, the M Company hires its own sales people and managerial help and pays their remuneration. Under the terms of the agreement, the employees of the M Company must conform to the rules and regulations of the N Department Store. At all times the M Company has at least 10 persons working in the department operated by it. The question presented is whether the M Company or the N Department Store should be treated as the "employer" of the particular employees.

Additional information regarding the relationship between the M Company and the N Department Store and of the circumstances under which the employees in the leased department perform services has been submitted. It is stated that the M Company's advertising is subject to the N Department Store's approval both as to text and the advertising medium. Porter service, cashiers, window trimmers, telephone service, customers' delivery service, sales books, and other equipment and facilities are furnished by the N Department Store. All of the M Company's records, including sales slips, may be inspected by the N Department Store, and it has the right to pass upon all credit sales made by the M Company. All sales, whether cash or credit, are made in the name of the N Department Store and the receipts therefrom are required to be turned over immediately to the N Department Store, which maintains records of all such funds and of all amounts which it disburses upon the M Company's authorization.

The M Company submits its pay rolls to the N Department Store, which, in turn, pays the individuals engaged by the M Company out of funds held by it. Wages paid to employees in the leased department are the same as those paid to similar employees in other departments, and such employees are eligible to participate in all privileges and benefits afforded to the employees of the N Department Store. In the event of a shortage of clerks in another of its departments, the N Department Store may assign a clerk temporarily from the leased department to such other department, or, if necessary, clerks from its regular departments may be assigned to the

leased department. Upon notice to the M Company by the N Department Store of a violation of the rules and regulations of the store by any employee in the leased department, the M Company may be required to discharge the particular employee. All controversies or adjustments between customers and the M Company or the employees in its department are subject to final settlement by the N Department Store. There is no indication to customers that the department is leased to the M Company by the N Department Store.

As a result of the further information submitted, the question of whether the lessor, the N Department Store, or the lessee, the M Company, is the "employer" of the individuals performing services in the leased department has been reconsidered.

Generally the relationship of "employer" and "employee" exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to *what* shall be done but *how* it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. (Article 205, Regulations 90; article 3, Regulations 91; section 402.204, Regulations 106; section 403.204, Regulations 107.)

It is apparent from a consideration of the facts and the pertinent regulations that the primary right of direction and control over the performance of services by the employees in the leased department is retained and exercised by the N Department Store. In exercising such control, the N Department Store is not acting as an agent of the M Company but is acting on its own behalf as principal. In view of the foregoing, it is held that the N Department Store is the "employer" for social security and employment tax purposes of the employees performing services in the department leased by the N Department Store to the M Company. Accordingly, S. S. T. 20, supra, is revoked.

SECTIONS 811 AND 907: Definitions. 1941-25-10753
REGULATIONS 91 AND 90, ARTICLES 6 AND 206(1): S. S. T. 418
Agricultural labor.
(Also Internal Revenue Code, Chapter 9, Subchapter A (Federal Insurance Contributions Act), Section 1426; Regulations 106, Section 402.208; and Subchapter C (Federal Unemployment Tax Act), Section 1607; Regulations 107, Section 403.208.)

Services performed by employees of the M Company on farms owned by that company in connection with the processing, grading, and baling of cigar leaf wrapper tobacco for market constitute "agricultural labor" within the meaning of sections 811(b)1 and 907(c)1 of the Social Security Act, section 1426(h) of the Federal Insurance Contributions Act, and section 1607(l) of the Federal Unemployment Tax Act.

S. S. T. 382 (C. B. 1940–1, 218) revoked and S. S. T. 219 (C. B. 1937–2, 412) reinstated.

The question is presented whether the services performed by employees of the M Company on farms owned by that company in connection with the processing, grading, and baling of cigar leaf wrapper tobacco for market constitute "agricultural labor" within the meaning of sections 811(b)1 and 907(c)1 of the Social Security Act, which except "agricultural labor" from "employment."

In S. S. T. 219 (C. B. 1937–2, 412) it was held that the services performed by employees of the M Company in its warehouses in connection with the fermenting, grading, and baling of cigar leaf wrapper tobacco grown on farms owned by the company constitute "agricultural labor," within the meaning of sections 811(b)1 and 907(c)1 of the Social Security Act. However, on reconsideration of this question after the submission of additional information, a contrary conclusion was reached, and S. S. T. 219, supra, was accordingly modified by S. S. T. 382 (C. B. 1940–1, 218).

Further additional information has now been presented relating to the nature of the services performed by the employees in connection with the above-mentioned activities, the manner in which such activities are ordinarily carried on, and the circumstances and conditions under which the company conducts such activities. This information, considered in conjunction with that previously submitted, indicates that the processing, grading, and baling of the cigar leaf wrapper tobacco produced on the farms of the company are carried on as an incident to ordinary farming operations within the meaning of article 6 of Regulations 91, relating to Title VIII of the Social Security Act, and article 206(l) of Regulations 90, relating to Title IX of that Act.

In view of the foregoing, it is held that services performed by employees of the M Company in connection with the processing, grading, and baling of cigar leaf wrapper tobacco produced on its farms constitute "agricultural labor" within the meaning of sections 811(b)1 and 907(c)1 of the Social Security Act and sections 1426(h) and 1607(l) of the Internal Revenue Code, as amended. Accordingly, S. S. T. 382, supra, is revoked and S. S. T. 219, supra, is reinstated.

The conclusion reached above is equally applicable to the status of such services under section 1426(h) of the Federal Insurance Contributions Act and section 1607(l) of the Federal Unemployment Tax Act.

SECTION 907: Definitions.
REGULATIONS 90, ARTICLE 204: Who are employers.

"Family employment" in the community property State of Texas. S. S. T. 256 (C. B. 1938–1, 425) revoked. (See S. S. T. 410, page 402.)

TITLE VIII.—TAXES WITH RESPECT TO EMPLOYMENT.

REGULATIONS 91, ARTICLE 13: Employees and employee representatives under the Carriers Taxing Act of 1937. 1941–1–10555 T. D. 5027

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PART 401.

Regulations 91, and such regulations as made applicable to the Internal Revenue Code by Treasury Decision 4885 [C. B. 1939–1 (Part 1), 396], amended to conform to certain provisions of the Joint Resolution approved June 11, 1940, and of the Act approved August 13, 1940.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

In order to conform Regulations 91 [Part 401, Title 26, Code of Federal Regulations], relating to the employees' tax and the employers' tax under Title VIII of the Social Security Act (49 Stat., 636; 42 U. S. C., Sup. V, 1001 to 1011, inclusive), and such regulations as made applicable to the Internal Revenue Code (53 Stat., Part 1; 26 U. S. C., Sup. V) by Treasury Decision 4885 [C. B. 1939–1 (Part 1), 396] [Chapter I, note, Title 26, Code of Federal Regulations, 1939 Sup.], to section 3 of the Joint Resolution approved June 11, 1940 (Public Resolution No. 81, Seventy-sixth Congress, third session), and to sections 1, 3, 4, and 6 of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, third session), each of such regulations is amended as follows:

(1) Immediately preceding article 13, as amended by Treasury Decision 4801 [C. B. 1938–1, 378] [section 401.13, Title 26, Code of Federal Regulations], the following is inserted:

Section 3 of the Joint Resolution approved June 11, 1940 (Public Resolution No. 81, Seventy-sixth Congress, Third Session).

Subsection (b) of section 1532 of the Internal Revenue Code, approved February 10, 1939 (53 Stat. 1), is hereby amended by substituting for the second proviso therein the following: "*Provided, however*, That an individual shall not be deemed to be in the employment relation to a carrier unless during the last pay-roll period in which he rendered service to it he was with respect to that service in the service of an employer in accordance with subsection (d) of this section."

Subsection (d) of section 1532 of said Code is hereby amended by changing the period at the end thereof to a colon and adding the following: "*Provided further*, That an individual not a citizen or resident of the United States shall not be deemed to be in the service of an employer when rendering service outside the United States to an employer who is required under the laws applicable in the place where the service is rendered to employ therein, in whole or in part, citizens or residents thereof; and the laws applicable on August 29, 1935, in the place where the service is rendered shall be deemed to have been applicable there at all times prior to that date."

The amendments in this section shall operate in the same manner and have the same effect as if they had been part of the Internal Revenue Code when that Code was enacted on February 10, 1939, and as if they had been part correspondingly of subsections (b) and (d) of the Carriers Taxing Act of 1937 (50 Stat. 435) when that Act was enacted on June 29, 1937.

Sections 1, 3, 4, and 6 of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, Third Session).

That * * * section 1(a) of the Carriers Taxing Act of 1937, section 1532(a) of the Internal Revenue Code, * * * are amended,

effective in the case of each such Act as of the date of its enactment, by adding at the end of each such section the following new sentence: "The term 'employer' shall not include any company by reason of its being engaged in the mining of coal, the supplying of coal to an employer where delivery is not beyond the mine tipple, and the operation of equipment or facilities therefor, or in any of such activities."

SEC. 3. * * * section 1(b) of the Carriers Taxing Act of 1937, section 1532(b) of the Internal Revenue Code, * * * are amended, in the case of each such Act as of the date of its enactment, by adding at the end of each such section * * * the following new paragraph:

"The term 'employee' shall not include any individual while such individual is engaged in the physical operations consisting of the mining of coal, the preparation of coal, the handling (other than movement by rail with standard railroad locomotives) of coal not beyond the mine tipple, or the loading of coal at the tipple."

SEC. 4. (a) The laws hereby expressly amended * * * shall operate as if each amendment herein contained had been enacted as a part of the law it amends, at the time of the original enactment of such law.

* * * * * * *

SEC. 6. Nothing contained in this Act, nor the action of Congress in adopting it, shall be taken or considered as affecting the question of what carriers, companies, or individuals, other than those in this Act specifically provided for, are included in or excluded from the provisions of the various laws to which this Act is an amendment.

(2) Article 13, as amended by Treasury Decision 4801 [supra] [section 401.13, Title 26, Code of Federal Regulations], is amended to read as follows:

ART. 13 [Sec. 401.13, Title 26, Code of Federal Regulations, 1940 Sup.]. *Employees and employee representatives under the Carriers Taxing Act of 1937 and Subchapter B of Chapter 9 of the Internal Revenue Code.*—Services performed by an individual as an "employee" or as an "employee representative," as those terms are defined in section 1 of the Carriers Taxing Act of 1937, as amended and modified, and section 1532 of the Internal Revenue Code, as amended, are excepted. (See also articles 3 and 4 of Regulations 100 [sections 410.3 and 410.4, Title 26, Code of Federal Regulations, and 1940 Sup.], relating to who are "employees" and "employee representatives.")

(3) Article 506, added by Treasury Decision 4801 [supra] [section 401.506, Title 26, Code of Federal Regulations], is amended by adding at the end thereof the following new sentence:

See, however, article 707 of Regulations 100 [section 410.707, Title 26, Code of Federal Regulations, 1940 Sup.], relating to the treatment under the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, third session), of taxes with respect to certain services performed in the employ of carriers by railroad.

(This Treasury decision is issued under the authority contained in section 808 of the Social Security Act (49 Stat., 638; 42 U. S. C., Sup. V, 1008), sections 1429 and 3791 of the Internal Revenue Code (53 Stat., 178, 467; 26 U. S. C., Sup. V, 1429, 3791), section 3 of the Joint Resolution approved June 11, 1940 (Public Resolution No. 81, Seventy-sixth Congress, third session), and sections 1, 3, 4, and 6 of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, third session).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved December 27, 1940.

HERBERT E. GASTON,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register December 30, 1940, 10.56 a. m.)

TITLE IX.—TAX ON EMPLOYERS OF EIGHT OR MORE.

REGULATIONS 90, ARTICLE 206(8): Employees and employee representatives under the Railroad Unemployment Insurance Act. 1941–1–10556 T. D. 5028

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PART 400.

Regulations 90, as made applicable to the Internal Revenue Code by Treasury Decision 4885 [C. B. 1939–1 (Part 1), 396], amended to conform to certain provisions of the Act approved August 13, 1940.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

In order to conform Regulations 90 [Part 400, Title 26, Code of Federal Regulations, and 1939 Sup. and 1940 Sup.] only as made applicable to the Internal Revenue Code (53 Stat., Part 1; 26 U. S. C., Sup. V) by Treasury Decision 4885 [C. B. 1939–1 (Part 1), 396] [Chapter I, note, Title 26, Code of Federal Regulations, 1939 Sup.], to sections 1, 3, 4, 6, and 7 of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, third session), such regulations, which relate to the Federal unemployment tax for the calendar year 1939, are amended as follows:

(1) The provisions of law under the caption "Section 1, as amended, of the Railroad Unemployment Insurance Act" immediately preceding article 206(8), added by Treasury Decision 4931 [C. B. 1939–2, 312] [section 400.206(8), Title 26, Code of Federal Regulations, 1939 Sup.], are stricken out, together with the caption, and the following is inserted in lieu thereof:

Section 1 of the Railroad Unemployment Insurance Act, as amended by the Act approved June 20, 1939 (53 Stat., 845).

For the purposes of this Act, except when used in amending the provisions of other Acts—

(a) The term "employer" means any carrier (as defined in subsection (b) of this section), and any company which is directly or indirectly owned or controlled by one or more such carriers or under common control therewith, and which operates any equipment or facility or performs any service (except trucking service, casual service, and the casual operation of equipment or facilities) in connection with the transportation of passengers or property by railroad, or the receipt, delivery, elevation, transfer in transit, refrigeration or icing, storage, or handling of property transported by railroad, and any receiver, trustee, or other individual or body, judicial or otherwise, when in the possession of the property or operating all or any part of the business of any such employer: *Provided, however*, That the term "employer" shall not include any street, interurban, or suburban electric railway, unless such railway is operating as a part of a general steam-railroad system of transportation, but shall not exclude any part of the general steam-railroad system of transportation now or hereafter operated by any other motive power. The Interstate Commerce Commission is hereby authorized and directed upon request of the Board, or upon complaint of any party interested, to determine after hearing whether any line operated by electric power falls within the terms of this proviso. The term "employer" shall also include railroad associations, traffic associations, tariff bureaus, demurrage bureaus, weighing and inspection bureaus, collection agencies, and other associations, bureaus, agencies, or organizations controlled and maintained wholly or principally by two or more employers as hereinbefore de-

fined and engaged in the performance of services in connection with or incidental to railroad transportation; and railway labor organizations, national in scope, which have been or may be organized in accordance with the provisions of the Railway Labor Act, and their State and National legislative committees and their general committees and their insurance departments and their local lodges and divisions, established pursuant to the constitution and bylaws of such organizations.

(b) The term "carrier" means an express company, sleeping-car company, or carrier by railroad, subject to part I of the Interstate Commerce Act.

(c) The term "company" includes corporations, associations, and joint-stock companies.

(d) The term "employee" (except when used in phrases establishing a different meaning) means any individual who is or has been (i) in the service of one or more employers for compensation, or (ii) an employee representative. The term "employee" shall include an employee of a local lodge or division defined as an employer in section 1(a) only if he was in the service of a carrier on or after August 29, 1935. The term "employee" includes an officer of an employer.

(e) An individual is in the service of an employer whether his service is rendered within or without the United States if he is subject to the continuing authority of the employer to supervise and direct the manner of rendition of his service, which service he renders for compensation: *Provided, however,* That an individual shall be deemed to be in the service of an employer not conducting the principal part of its business in the United States only when he is rendering service to it in the United States: *Provided further,* That an individual not a citizen or resident of the United States shall not be deemed to be in the service of an employer when rendering service outside the United States to an employer who is required under the laws applicable in the place where the service is rendered to employ therein, in whole or in part, citizens or residents thereof.

(f) The term "employee representative" means any officer or official representative of a railway labor organization other than a labor organization included in the term employer as defined in section 1(a) who before or after August 29, 1935, was in the service of an employer as defined in section 1(a) and who is duly authorized and designated to represent employees in accordance with the Railway Labor Act, and any individual who is regularly assigned to or regularly employed by such officer or official representative in connection with the duties of his office.

* * * * * * *

(i) The term "compensation" means any form of money remuneration, including pay for time lost but excluding tips, payable for services rendered as an employee to one or more employers, or as an employee representative: *Provided, however,* That in computing the compensation payable to any employee with respect to any calendar month, no part of any compensation in excess of $300 shall be recognized.

* * * * * * *

(r) The term "Board" means the Railroad Retirement Board.

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

* * * * * * *

Sections 1, 3, 4, and 6 of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, Third Session).

That * * * section 1(a) of the Railroad Unemployment Insurance Act are amended, effective * * * as of the date of its enactment, by adding at the end of * * * such section the following new sentence: "The term 'employer' shall not include any company by reason of its being engaged in the mining of coal, the supplying of coal to an employer where delivery is not beyond the mine tipple, and the operation of equipment or facilities therefor, or in any of such activities."

SEC. 3. * * * section 1(d) of the Railroad Unemployment Insurance Act * * * are amended, * * * as of the date of its enactment, by adding at the end of * * * such section * * * the following new paragraph:

"The term 'employee' shall not include any individual while such individual is engaged in the physical operations consisting of the mining of coal, the preparation of coal, the handling (other than movement by rail with standard railroad locomotives) of coal not beyond the mine tipple, or the loading of coal at the tipple."

SEC. 4. (a) The laws hereby expressly amended * * * shall operate as if each amendment herein contained had been enacted as a part of the law it amends, at the time of the original enactment of such law.

* * * * * *

SEC. 6. Nothing contained in this Act, nor the action of Congress in adopting it, shall be taken or considered as affecting the question of what carriers, companies, or individuals, other than those in this Act specifically provided for, are included in or excluded from the provisions of the various laws to which this Act is an amendment.

(2) Article 206(8), added by Treasury Decision 4931 [supra] [section 400.206(8), Title 26, Code of Federal Regulations, 1939 Sup.], is amended to read as follows:

ART. 206(8) [Sec. 400.206(8), Title 26, Code of Federal Regulations, 1940 Sup.]. *Employees and employee representatives under the Railroad Unemployment Insurance Act.*—Services performed on or after July 1, 1939, by an individual as an "employee" or as an "employee representative," as those terms are defined in section 1 of the Railroad Unemployment Insurance Act, as amended, are excepted.

(3) Immediately preceding article 211(1), added by Treasury Decision 4953 [C. B. 1939–2, 297] [section 400.211(1), Title 26, Code of Federal Regulations, 1939 Sup.], as amended by Treasury Decision 5022 [C. B. 1940–2, 275] [section 400.211(1) of such Title 26, 1940 Sup.], the following is inserted:

Section 7(b) of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, Third Session).

Notwithstanding the provisions of section 1601(a)(3) of the Internal Revenue Code, the credit allowable under section 1601(a) against the tax imposed by section 1600 for the calendar year 1939 shall not be disallowed or reduced by reason of the payment into a State unemployment fund after January 31, 1940, of contributions with respect to services affected by this Act performed during the period July 1, 1939, to December 31, 1939, inclusive, with respect to which services amounts have been paid as contributions under the Railroad Unemployment Insurance Act prior to the date of enactment of this Act: *Provided*, That this subsection shall be applicable only if the contributions with respect to such services are paid into the State unemployment fund before the ninetieth day after the date of enactment of this Act.

(4) Article 211(1)(*b*), added by Treasury Decision 4953 [supra] [section 400.211(1)(*b*), Title 26, Code of Federal Regulations, 1939 Sup.], as amended by Treasury Decision 5022 [supra] [section 400.211(1)(*b*) of such Title 26, 1940 Sup.], is amended by inserting immediately following paragraph (2) thereof the following new paragraph:

(See, however, section 7(b) of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, third session), for a special provision relating to credit for certain contributions paid with respect to certain services affected by such Act; and see sections 1, 3, 4, and 6 of such Act quoted immediately preceding article 206(8) [section 400.206(8), Title 26, Code of Federal Regulations, 1940 Sup.], relating to such services.)

(5) Immediately following the provisions of law under the caption "Section 905(a) of the Act" preceding article 502 [section 400.502, Title 26, Code of Federal Regulations], the following is inserted:

Section 7(a) of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, Third Session).

Notwithstanding the provisions of section 1605(b) of the Internal Revenue Code, no interest shall, during the period February 1, 1940, to the eighty-ninth day after the date of enactment of this Act, inclusive, accrue by reason of delinquency in the payment of the tax imposed by section 1600 with respect to services affected by this Act performed during the period July 1, 1939, to December 31, 1939, inclusive, with respect to which services amounts have been paid as contributions under the Railroad Unemployment Insurance Act prior to the date of enactment of this Act.

(6) Article 502 [section 400.502, Title 26, Code of Federal Regulations] is amended by adding at the end thereof the following new paragraph:

(See, however, section 7(a) of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, third session), for a special provision relating to interest on the tax with respect to certain services affected by such Act; and see sections 1, 3, 4, and 6 of such Act quoted immediately preceding article 206(8) [section 400.206(8), Title 26, Code of Federal Regulations, 1940 Sup.], relating to such services.)

(This Treasury decision is issued under the authority contained in sections 1609 and 3791 of the Internal Revenue Code (53 Stat., 188, 467; 26 U. S. C., Sup. V, 1609, 3791), and sections 1, 3, 4, 6, and 7 of the Act approved August 13, 1940 (Public, No. 764, Seventy-sixth Congress, third session).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved December 27, 1940.

HERBERT E. GASTON,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register December 30, 1940, 10.56 a. m.)

CARRIERS TAXING ACT OF 1937.

REGULATIONS 100.

Exemption from taxation of certain compensation earned in the service of a local lodge or division of a railway labor organization employer. (See T. D. 5029, page 409.)

MISCELLANEOUS TAX RULINGS.

ESTATE TAX.

INTERNAL REVENUE CODE.

REGULATIONS 80 (1937), ARTICLE 13: Property of decedent at time of death. 1941-10-10633 T. D. 5042

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER B, PART 80.—ESTATE TAX.

Article 13, Regulations 80 (1937 edition), amended.—Bonds, notes, and certificates of indebtedness of the United States, issued on or after March 1, 1941, beneficially owned by nonresident aliens not engaged in business in the United States, included in gross estate.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

Article 13 of Regulations 80, 1937 edition [section 80.13, Title 26, Code of Federal Regulations], as made applicable to the Internal Revenue Code (53 Stat., Part 1) by Treasury Decision 4885, approved February 11, 1939 [C. B. 1939-1 (Part 1), 396] [Chapter I, note, Title 26, Code of Federal Regulations, 1939 Sup.], is amended as herein indicated.

In lieu of the last sentence of article 13, which reads:

However, in case the decedent was a nonresident alien not engaged in business in the United States, bonds, notes, and certificates of indebtedness of the United States, beneficially owned by such alien, should not be included.—

the following is substituted:

In case the decedent was a nonresident alien not engaged in business in the United States, bonds, notes, and certificates of indebtedness of the United States, beneficially owned by such alien should not be included; however, bonds, notes, and certificates of indebtedness of the United States, issued on or after March 1, 1941, which such decedent beneficially owned, should be included in the gross estate.

(This Treasury decision is issued under the authority contained in the following sections of law: Sections 811, 937, and 3791 of the Internal Revenue Code (53 Stat., 120, 143, and 467 (26 U. S. C., Sup. V, sections 811, 937, 3791)).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved March 1, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register March 3, 1941, 3.52 p. m.)

REGULATIONS 80 (1937), ARTICLE 11: Optional valuation date. 1941-22-10727
ARTICLE 13: Property of decedent at time of death. T. D. 5047

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER B, PART 80.—ESTATE TAX.

Articles 11 and 13, Regulations 80 (1937 Edition), amended.—Optional valuation of gross estate.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

Article 11, and article 13 (as amended by Treasury Decision 5042, approved March 1, 1941 [page 424, this Bulletin]) of Regulations 80, 1937 Edition [sections 80.11 and 80.13, Title 26, Code of Federal Regulations], and those articles as made applicable to the Internal Revenue Code (53 Stat., Part 1) by Treasury Decision 4885, approved February 11, 1939 [C. B. 1939-1 (Part 1), 396] [Chapter I, note, of such Title 26], are amended as herein indicated.

In lieu of the sixth, seventh, eighth, ninth, tenth, and eleventh paragraphs of article 11, the following is substituted:

In valuing the gross estate under the optional valuation method, all of the property interests existing at the date of death which are a part of the gross estate as determined under the subdivisions of section 302, as amended, constitute the property to be valued as of one year after the date of the decedent's death, or as of the date of the decedent's death, or as of some intermediate date. Such property is hereinafter referred to as "included property." "Included property" as of the date of the decedent's death remains "included property" for the purpose of valuing the gross estate under the optional valuation method even though it is changed in form during the optional valuation period by being actually received, or disposed of, in whole or in part, by the estate. However, property earned or accrued (whether received or not) after the decedent's death and during the optional valuation period with respect to any property interest existing at the date of death, which does not represent a form of "included property" itself or the receipt thereof, is to be excluded in valuing the gross estate at the subsequent valuation date and is hereinafter referred to as "excluded property." Among the items of "included property" to be valued in accordance with these principles are the following:

1. *Interest-bearing obligations.*—Interest-bearing obligations, such as bonds and notes, may, at the date of death, comprise two elements of "included property," the principal of the obligation itself and interest accrued to the date of death, and each is to be separately valued as of the applicable valuation date. The bond or note is to be valued as of the applicable valuation date without regard to accrued interest. Interest accrued after the date of death and prior to the subsequent valuation date constitutes "excluded property." However, any part payment of principal made between the date of death and the subsequent valuation date, or any advance payment of interest for a period after the subsequent valuation date made during the optional valuation period which has the effect of reducing the value of the principal obligation as of the subsequent valuation date, will be included in the gross estate, and valued as of the date of such payment.

2. *Leased property.*—The principles applicable with respect to interest-bearing obligations also apply to leased realty or personalty included in the gross estate with the obligation to pay rent reserved. Both the realty or personalty itself and the rents accrued to the date of death constitute "included property," and each is to be separately valued as of the applicable valuation date. Any rent accrued after the date of death and prior to the subsequent valuation date is "excluded property." The principle applicable with respect to interest paid in advance also applies to advance payments of rent.

3. *Noninterest-bearing obligations.*—In the case of noninterest-bearing obligations sold at a discount, such as Treasury bills, the principal obligation and the discount amortized to the date of death are property interests existing at the date of death and constitute "included property." The obligation itself is to be valued thereafter at the subsequent valuation date without regard to any further increase in value due to amortized discount. The additional discount amortized after death and during the optional valuation period is the equivalent of interest accruing during that period and is, therefore, not to be included in the gross estate under the optional valuation method.

4. *Stock of a corporation.*—Shares of stock in a corporation and dividends declared to stockholders of record on or before the date of the decedent's death and not collected at the date of death constitute "included property" of the estate. Ordinary dividends out of earnings and profits, whether in cash or in shares of the corporation or in other property, declared to stockholders of record after the date of the decedent's death are "excluded property" and are not to be valued under the optional valuation method. If, however, dividends are declared to stockholders of record after the date of the decedent's death with the effect that the shares of stock at the subsequent valuation date do not reasonably represent the same "included property" of the gross estate as existed at the date of the decedent's death, such dividends are "included property" except to the extent that such dividends are out of earnings of the corporation after the date of the decedent's death. For example, if a corporation makes a distribution in complete or partial liquidation to stockholders of record during the optional valuation period, the amount of such distribution received on stock included in the gross estate is itself "included property," except to the extent that the distribution was out of earnings and profits since the date of the decedent's death. Another example is where a corporation, in which the decedent owned 50 per cent of the shares and which possessed at the date of the decedent's death accumulated earnings and profits equal to its paid-in capital, distributed all of its accumulated earnings and profits as a cash dividend to shareholders of record during the optional valuation period. In such a case the amount of the dividends received on stock includible in the gross estate will be included in the gross estate under the optional valuation method.

The operation of this article may be further illustrated by the following example in which the death of the decedent will be taken to have occurred on January 1, 1940:

Description.	Subsequent valuation date.	Value under option.	Value at date of death.
Bond, par value $1,000, bearing interest at 4 per cent payable quarterly on Feb. 1, May 1, Aug. 1, and Nov. 1. Bond distributed to legatee on Mar. 1, 1940	Mar. 1, 1940	$1,000.00	$1,000.00
Interest coupon of $10 attached to bond and not cashed at date of death although due and payable Nov. 1, 1939. Cashed by executor on Feb. 1, 1940	Feb. 1, 1940	10.00	10.00
Interest accrued from Nov. 1, 1939, to Jan. 1, 1940	Feb. 1, 1940	6.67	6.67
Real estate. Not disposed of within year following death. Rent of $300 due at the end of each quarter, Feb. 1, May 1, Aug. 1, and Nov. 1	Jan. 1, 1941	11,000.00	12,000.00
Rent due for quarter ending Nov. 1, 1939, but not collected until Feb. 1, 1940	Feb. 1, 1940	300.00	300.00
Rent accrued for November and December, 1939	Feb. 1, 1940	200.00	200.00
Common stock, X Corporation, 500 shares, not disposed of within year following decedent's death	Jan. 1, 1941	47,500.00	50,000.00
Dividend of $2 per share declared Dec. 10, 1939, payable on Jan. 10, 1940, to holders of record on Dec. 30, 1939	Jan. 10, 1940	1,000.00	1,000.00

In lieu of the second sentence of the last paragraph of article 11, the following is substituted:

Interest and rents accrued at the date of the decedent's death and dividends declared to stockholders of record on or before the date of the decedent's death and not collected at such date shall be separately shown.

In lieu of the sixth, seventh, and eighth paragraphs of article 13, the following is substituted:

Interest and rents accrued at the date of the decedent's death and dividends declared to stockholders of record on or before the date of the decedent's death and not collected at such date constitute part of the gross estate.

(This Treasury decision is issued under the authority contained in the following sections of law: Sections 811, 937, and 3791 of the Internal Revenue Code (53 Stat., 120, 143, and 467, 26 U. S. C., Sup. V, 811, 937, 3791); section 302 of the Revenue Act of 1926 (44 Stat., 70, 26 U. S. C., 411) as amended by section 202 of the Revenue Act of 1935 (49 Stat., 1022, 26 U. S. C., Sup. V, 811); section 1101 of the Revenue Act of 1926 (44 Stat., 111, 26 U. S. C., 1691(a)(1)); section 403 of the Revenue Act of 1932 (47 Stat., 245, 26 U. S. C., 537); and section 1108(a) of the Revenue Act of 1926, as amended by section 605 of the Revenue Act of 1928 and by section 506 of the Revenue Act of 1934 (44 Stat., 114, 45 Stat., 874, 48 Stat., 757, 26 U. S. C., 1691(b)).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved May 22, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register May 24, 1941, 12.17 p. m.)

REGULATIONS 80 (1937), ARTICLE 25: Taxable insurance.
ARTICLE 26: Insurance in favor of the estate.
ARTICLE 27: Insurance receivable by other beneficiaries.

1941-3-1057C
T. D. 5032

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER B, PART 80.—ESTATE TAX.

Articles 25, 26, and 27, Regulations 80 (1937 edition), amended.—Proceeds of insurance upon the life of the decedent includible in his gross estate.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

Article 25, article 26 (as amended by Treasury Decision 4868, approved October 24, 1938 [C. B. 1938-2, 355]), and article 27 of Regulations 80, 1937 edition [sections 80.25, 80.26, and 80.27, Title 26, Code of Federal Regulations], and those articles as made applicable to the Internal Revenue Code (53 Stat., Part 1) by Treasury Decision 4885, approved February 11, 1939 [C. B. 1939-1 (Part 1), 396] [Part 465, Subpart B, Title 26, Code of Federal Regulations, 1939 Sup.], are amended as herein indicated.

In lieu of the second paragraph of article 25, which reads:

The term "insurance" refers to life insurance of every description, including death benefits paid by fraternal beneficial societies, operating under the lodge system. Insurance is considered to have been taken out by the decedent, whether or not he made the application, if he acquired the ownership of, or any legal incident thereof in, the policy; but in the case of a decedent dying before November 7, 1934 (the date of approval of the 1934 edition of Regulations 80), the provisions of the second paragraph of article 25 of Regulations 70 (1929 edition) will continue to apply. Legal incidents of ownership in the policy include, for example: The right of the insured or his estate to its economic benefits, the power to change the

beneficiary, to surrender or cancel the policy, to assign it, to revoke an assignment, to pledge it for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc.—

the following is substituted:

The term "insurance" refers to life insurance of every description, including death benefits paid by fraternal beneficial societies operating under the lodge system. Insurance receivable by beneficiaries other than the estate is considered to have been taken out by the decedent where he paid, either directly or indirectly, all the premiums or other consideration wherewith the insurance was acquired, whether or not he made the application. Such insurance is not considered to have been so taken out, even though the application was made by the decedent, if no part of the premiums or other consideration was paid either directly or indirectly by him. Where a portion of the premiums or other consideration was actually paid by another and the remaining portion by the decedent, either directly or indirectly, such insurance is considered to have been taken out by the latter in the proportion that the payments therefor made by him bear to the total amount paid for the insurance.

Life insurance not includible in the gross estate under the provisions of subdivision (g) of section 302 and article 26, 27, or this article of these regulations may, depending upon the facts of the particular case, be includible under some other subdivision of section 302 and the articles of these regulations pertaining thereto, such as subdivision (c) in the case of insurance taken out by the decedent prior to the date of Treasury Decision 5032 and also transferred by him prior to such date in contemplation of death.

Article 26 (as amended by Treasury Decision 4868, approved October 24, 1938), which reads—

ART. 26. *Insurance in favor of the estate.*—The provision requiring the inclusion in the gross estate of all insurance receivable by the executor, without any exemption, applies to policies made payable to the decedent's estate or his executor or administrator, and all insurance which is in fact receivable by, or for the benefit of, the estate. It includes insurance taken out to provide funds to meet the estate tax, and any other taxes or charges which are enforceable against the estate. The manner in which the policy is drawn is immaterial so long as there is an obligation, legally binding upon the beneficiary, to use the proceeds in payment of such taxes or charges. If the decedent took out insurance in favor of another person or corporation as collateral security for a loan or other accommodation, the insurance is considered to be receivable for the benefit of the estate. The amount of the loan outstanding at decedent's death will be deductible in determining the net estate, and the interest thereon will be deductible in accordance with the provisions of article 36.—

is amended to read as follows:

ART. 26. *Insurance in favor of the estate.*—The statute requires the inclusion in the gross estate of all insurance receivable by the executor or administrator or payable to the decedent's estate, and all insurance which is in fact receivable by, or for the benefit of, the estate. It includes insurance effected to provide funds to meet the estate tax, and any other taxes, debts, or charges which are enforceable against the estate. The manner in which the policy is drawn is immaterial so long as there is an obligation, legally binding upon the beneficiary, to use the proceeds in payment of such taxes, debts, or charges. The full amount of the proceeds so receivable, without the benefit of any exemption, forms a part of the gross estate, though all the premiums or other consideration wherewith the insurance was acquired may have been paid by a person other than the decedent. If the decedent procured insurance in favor of another person or corporation as collateral security for a loan or other accommodation, the insurance is considered to be receivable for the benefit of the estate. The amount of the loan outstanding at decedent's death will be deductible in determining the net estate, and the interest thereon will be deductible in accordance with the provisions of article 36.

Article 27, which reads—

ART. 27. *Insurance receivable by other beneficiaries.*—The statute requires the inclusion in the gross estate of the decedent of the proceeds of any policy, or the aggregate proceeds of all policies, not receivable by or for the benefit of decedent's

estate, to the extent that such proceeds exceed $40,000, regardless of when the policy was or the policies were issued, if the decedent possessed at the time of his death any of the legal incidents of ownership.

The estate is entitled to only one exemption of $40,000 upon insurance receivable by beneficiaries other than the estate. For example, if the decedent left life insurance payable to three such beneficiaries in amounts of $10,000, $40,000, and $50,000 (total, $100,000), the full amount should be listed on the return and therefrom subtracted the $40,000 exemption as provided in the appropriate schedule of Form 706. The word "beneficiaries," as used in reference to the $40,000 exemption, means persons entitled to the actual enjoyment of the insurance money.—

is amended to read as follows:

ART. 27. *Insurance receivable by other beneficiaries.*—The amount in excess of $40,000 of the aggregate proceeds of all insurance on the decedent's life not receivable by or for the benefit of his estate must be included in his gross estate as follows:

(1) To the extent to which such insurance was taken out by the decedent upon his own life (see article 25) after January 10, 1941, the date of Treasury Decision 5032, and

(2) To the extent to which such insurance was taken out by the decedent upon his own life (see article 25) on or before January 10, 1941, and with respect to which the decedent possessed any of the legal incidents of ownership at any time after such date or, in the case of a decedent dying on or before such date, at the time of his death.

Legal incidents of ownership in the policy include, for example, the right of the insured or his estate to its economic benefits, the power to change the beneficiary, to surrender or cancel the policy, to assign it, to revoke an assignment, to pledge it for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc. The insured possesses a legal incident of ownership if his death is necessary to terminate his interest in the insurance, as, for example if the proceeds would become payable to his estate, or payable as he might direct, should the beneficiary predecease him.

The estate is entitled to only one exemption of $40,000 upon insurance receivable by beneficiaries other than the estate. For instance, if the decedent left life insurance otherwise includible under the provisions of this article and payable to three such beneficiaries in amounts of $10,000, $40,000, and $50,000 (total, $100,000), the full amount should be listed on the return and therefrom subtracted the $40,000 exemption as provided in the appropriate schedule of Form 706. The word "beneficiaries," as used in reference to this $40,000 exemption, means persons entitled to the actual enjoyment of the insurance money.

Example: Insurance on the life of the decedent who died after the date of Treasury Decision 5032 totaled $200,000. It was payable to his son as beneficiary and the decedent never possessed any of the legal incidents of ownership therein. Premiums aggregating $100,000 were paid for the insurance, of which the decedent paid $50,000 before the date of Treasury Decision 5032 and $30,000 after that date. The remaining premiums of $20,000 were paid by the son. The extent to which the insurance was taken out by the decedent after the date of the Treasury decision is the proportion of $200,000 that the amount of the premiums paid by him after such date, $30,000, bears to the total amount of the premiums paid for the insurance, $100,000. Such proportion is three-tenths of $200,000, or $60,000. As the decedent possessed none of the legal incidents of ownership in the insurance at any time after the date of the Treasury decision, $100,000 of the insurance, the extent to which it was taken out by the decedent before such date $\left(\frac{50,000}{100,000} \times \$200,000\right)$, is excluded from the gross estate. The amount of $40,000, the extent to which the insurance was not taken out by the decedent $\left(\frac{20,000}{100,000} \times \$200,000\right)$, is also excluded from the gross estate. The amount of the insurance taken out by the decedent after the date of the Treasury decision, $60,000, is reduced by $40,000, the special insurance exemption, and the amount of the insurance included in the gross estate is $20,000.

(This Treasury decision is issued under the authority contained in the following sections of law: Sections 811, 937, and 3791 of the

Internal Revenue Code (53 Stat., 120, 143, and 467); section 302 of the Revenue Act of 1926 (44 Stat., 70, 26 U. S. C., 411); section 1101 of the Revenue Act of 1926 (44 Stat., 111, 26 U. S. C., 1691(a)1); section 403 of the Revenue Act of 1932 (47 Stat., 245, 26 U. S. C., 537); and section 1108(a) of the Revenue Act of 1926, as amended by section 605 of the Revenue Act of 1928 and by section 506 of the Revenue Act of 1934 (44 Stat., 114, 45 Stat., 874, 48 Stat., 757, 26 U. S. C., 1691(b)).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved January 10, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register January 13, 1941, 11.45 a. m.)

TITLE III.—ESTATE TAX. (1926)

SECTION 302(g), AS AMENDED.

REGULATIONS 80 (1934), ARTICLE 25: Taxable insurance. 1941-11-10638 Ct. D. 1491

ESTATE TAX—REVENUE ACT OF 1926, AS AMENDED—DECISION OF SUPREME COURT.

1. GROSS ESTATE—INSURANCE—SINGLE PREMIUM POLICY AND ANNUITY CONTRACT PURCHASED BY UNINSURABLE—TRANSFER TO TAKE EFFECT IN POSSESSION OR ENJOYMENT AT OR AFTER DEATH.

Proceeds of a single premium life insurance policy purchased by decedent at the age of 80 in conjunction with a single premium annuity contract are not amounts "receivable * * * as insurance" within the meaning of section 302(g) of the Revenue Act of 1926, as amended. Although the two contracts were in all formal respects treated as distinct transactions, the "insurance" policy would not have been issued without the annuity contract, and the two must be considered together. So considered, they wholly fail to spell out any element of insurance risk. The amounts receivable by the beneficiary are taxable under section 302(c) of the Revenue Act of 1926, as amended, as a transfer to take effect in possession or enjoyment at or after death.

2. DECISION REVERSED.

Decision of the United States Circuit Court of Appeals, Second Circuit (1940) (110 Fed. (2d), 734), affirming decision of the United States Board of Tax Appeals (1939) (39 B. T. A., 1134), reversed.

SUPREME COURT OF THE UNITED STATES.

Guy T. Helvering, petitioner, v. *Edyth Le Gierse and Bankers Trust Co., respondents.*

[61 S. Ct., 646.]

On writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[March 3, 1941.]

OPINION.

Mr. Justice MURPHY delivered the opinion of the Court.

Less than a month before her death in 1936, decedent, at the age of 80, executed two contracts with the Connecticut General Life Insurance Co. One was an annuity contract in standard form entitling decedent to annual payments of $589.80 as long as she lived. The consideration stated for this contract was

$4,179. The other contract was called a "Single Premium Life Policy—Non Participating" and provided for a payment of $25,000 to decedent's daughter, respondent Le Gierse, at decedent's death. The premium specified was $22,946. Decedent paid the total consideration, $27,125, at the time the contracts were executed. She was not required to pass a physical examination or to answer the questions a woman applicant normally must answer.

The "insurance" policy would not have been issued without the annuity contract, but in all formal respects the two were treated as distinct transactions. Neither contract referred to the other. Independent applications were filed for each. Neither premium was computed with reference to the other. Premium payments were reported separately and entered in different accounts on the company's books. Separate reserves were maintained for insurance and annunities. Each contract was in standard form. The "insurance" policy contained the usual provisions for surrender, assignment, optional modes of settlement, etc.

Upon decedent's death, the face value of the "insurance" contract became payable to respondent Le Gierse, the beneficiary. Thereafter, a Federal estate tax return was filed which excluded from decedent's gross estate the proceeds of the "insurance" policy. The Commissioner notified respondents Bankers Trust Co. and Le Gierse, as executors of decedent's estate, that he proposed to include the proceeds of this policy in the gross estate and to assess a deficiency. Suit in the Board of Tax Appeals followed, and the Commissioner's action was reversed. (39 B. T. A., 1134.) The circuit court of appeals affirmed. (110 Fed. (2d), 734.) We brought the case here because of conflict with *Commissioner* v. *Keller* (113 Fed. (2d), 833) and *Helvering* v. *Tyler* (111 Fed. (2d), 422; 311 U. S., —).

The ultimate question is whether the "insurance" proceeds may be included in decedent's gross estate.

Section 302 of the Revenue Act of 1926 (44 Stat., 9, 70; as amended, 47 Stat., 169, 279; 48 Stat., 680, 752) provides: "The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible * * *—(g) To the extent of the amount receivable by the executor as insurance under policies taken out by the decedent upon his own life; and to the extent of the excess over $40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life." Thus the basic question is whether the amounts received here are amounts "receivable as insurance" within the meaning of section 302(g).

Conventional aids to construction are of little assistance here. Section 302(g) first appeared in identical language in the Revenue Act of 1918 as section 402(f). (40 Stat., 1057, 1098.) It has never been changed.[1] None of the Acts has ever defined "insurance." Treasury regulations, interpreting the original provision, stated simply: "The term 'insurance'" refers to life insurance of every description, including death benefits paid by fraternal beneficial societies, operating under the lodge system." (Treasury Regulations No. 37, 1921 edition, page 23.) This statement has never been amplified.[2] The committee report accompanying the Revenue Act of 1918 merely noted that the provision taxing insurance receivable by the executor clarified existing law, and that the provision taxing insurance in excess of $40,000 receivable by specific beneficiaries was inserted to prevent tax evasion. (House Report No. 767, Sixty-fifth Congress, second session, page 22 [C. B. 1939–1 (Part 2), 86].[3]) Subsequent committee reports do not mention section 302(g). Transcripts of committee hearings in 1918 and since are equally uninformative.[4]

[1] Act of 1921: 42 Stat., 227, 279; Act of 1924: 43 Stat., 253, 305; Act of 1926: 44 Stat., 9, 71; Code of 1939: 53 Stat., 1, 122.

[2] Regulations No. 63, page 26; Regulations No. 68, page 31; Regulations No. 70, 1926 edition, page 30; Regulations No. 70, 1929 edition, page 33; Regulations No. 80, page 62.

[3] "* * * [Insurance payable to specific beneficiaries does] not fall within the existing provisions defining gross estate. It has been brought to the attention of the committee that wealthy persons have and now anticipate resorting to this method of defeating the estate tax. Agents of insurance companies have openly urged persons of wealth to take out additional insurance payable to specific beneficiaries for the reason that such insurance would not be included in the gross estate. A liberal exemption of $40,000 has been included and it seems not unreasonable to require the inclusion of amounts in excess of this sum." (*Id.*, page 22.)

The same comment appears in Senate Report No. 617, Sixty-fifth Congress, third session, page 42 [C. B. 1939–1 (Part 2), 117].

[4] The curious consistency and inadequacy of section 302(g) have not escaped notice. See Paul, Life Insurance and The Federal Estate Tax (52 Har. L. Rev., 1037); Paul, Studies in Federal Taxation, 3d Series, page 351; *United States Trust Co.* v. *Sears* (29 Fed. Supp., 643, 650).

Necessarily, then, the language and the apparent purpose of section 302(g) are virtually the only bases for determining what Congress intended to bring within the scope of the phrase "receivable as insurance." In fact, in using the term "insurance" Congress has identified the characteristic that determines what transactions are entitled to the partial exemption of section 302(g).

We think the fair import of subsection (g) is that the amounts must be received as the result of a transaction which involved an actual "insurance risk" at the time the transaction was executed. Historically and commonly insurance involves risk-shifting and risk-distributing. That life insurance is desirable from an economic and social standpoint as a device to shift and distribute risk of loss from premature death is unquestionable. That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators. See for example: *Ritter* v. *Mutual Life Ins. Co.* (169 U. S., 139); *In re Walsh* (19 Fed. Supp., 567); *Guaranty Trust Co.* v. *Commissioner* (16 B. T. A., 314); *Ackerman* v. *Commissioner* (15 B. T. A., 635); Couch, Cyclopedia of Insurance, Volume I, section 61; Vance, Insurance, sections 1–3; Cooley, Briefs on Insurance, 2d edition, Volume I, page 114; Huebner, Life Insurance, Chapter 1. Accordingly, it is logical to assume that when Congress used the words "receivable as insurance" in section 302(g), it contemplated amounts received pursuant to a transaction possessing these features. (*Commissioner* v. *Keller*, supra; *Helvering* v. *Tyler*, supra; *Old Colony Trust Co.* v. *Commissioner*, 102 Fed. (2d), 380 [Ct. D. 1429, C. B. 1939–2, 332]; *Ackerman* v. *Commissioner*, supra.)

Analysis of the apparent purpose of the partial exemption granted in section 302(g) strengthens the assumption that Congress used the word "insurance" in its commonly accepted sense. Implicit in this provision is acknowledgment of the fact that usually insurance payable to specific beneficiaries is designed to shift to a group of individuals the risk of premature death of the one upon whom the beneficiaries are dependent for support. Indeed, the pith of the exemption is particular protection of contracts and their proceeds intended to guard against just such a risk. (See *Commissioner* v. *Keller*, supra; *United States Trust Co.* v. *Sears*, 29 Fed Supp., 643; Hughes, Federal Death Tax, page 91; Comment, 38 Mich. L. Rev., 526, 528; compare *Chase National Bank* v. *United States*, 28 Fed. Supp., 947; *In re Walsh*, supra; *Moskowitz* v. *Davis*, 68 Fed. (2d), 818.) Hence, the next question is whether the transaction in suit in fact involved an "insurance risk" as outlined above.

We can not find such an insurance risk in the contracts between decedent and the insurance company.

The two contracts must be considered together. To say they are distinct transactions is to ignore actuality, for it is conceded on all sides and was found as a fact by the Board of Tax Appeals that the "insurance" policy would not have been issued without the annuity contract. Failure, even studious failure, in one contract to refer to the other can not be controlling. Moreover, authority for such consideration is not wanting, however unrealistic the distinction between form and substance may be. (*Commissioner* v. *Keller*, supra; *Helvering* v. *Tyler*, supra. See Williston, Contracts, Volume III, section 628; Paul, Studies in Federal Taxation, 2d series, page 218; compare *Pearson* v. *McGraw*, 308 U. S., 313.[5])

Considered together, the contracts wholly fail to spell out any element of insurance risk. It is true that the "insurance" contract looks like an insurance policy, contains all the usual provisions of one, and could have been assigned or surrendered without the annuity. Certainly the mere presence of the customary provisions does not create risk, and the fact that the policy could have been assigned is immaterial since no matter who held the policy and the annuity, the two contracts, relating to the life of the one to whom they were originally issued, still counteracted each other. It may well be true that if enough people of decedent's age wanted such a policy it would be issued without the annuity, or that if the instant policy had been surrendered a risk would have arisen. In either event the essential relation between the two parties would be different from what it is here. The fact remains that annuity and insurance are opposites; in this combination the one neutralizes the risk customarily inherent in the other. From the company's viewpoint, insurance looks to longevity, annuity to transiency. (See *Commissioner* v. *Keller*, supra; *Helvering* v. *Tyler*, supra; *Old Colony Trust Co.* v. *Commissioner*, supra; *Carroll* v. *Equitable Life Assur. Soc.*, 9 Fed. Supp., 223; Note, 49 Yale L. J., 946; Cohen, Annuities and Transfer Taxes, 7 Kan. B. A. J., 139.)

[5] *Legg* v. *St. John* (296 U. S., 489) is not to the contrary. There nothing indicated that the one contract would not have been issued without the other; there was no necessary connection between the two.

Here the total consideration was prepaid and exceeded the face value of the "insurance" policy. The excess financed loading and other incidental charges. Any risk that the prepayment would earn less than the amount paid to respondent as an annuity was an investment risk similar to the risk assumed by a bank; it was not an insurance risk as explained above. It follows that the sums payable to a specific beneficiary here are not within the scope of section 302(g). The only remaining question is whether they are taxable.

We hold that they are taxable under section 302(c) of the Revenue Act of 1926, as amended, as a transfer to take effect in possession or enjoyment at or after death. (See *Helvering* v. *Tyler*, supra; *Old Colony Trust Co.* v. *Commissioner*, supra; *Kernochan* v. *United States*, 29 Fed. Supp., 860; *Guaranty Trust Co.* v. *Commissioner*, supra; compare, *Gaither* v. *Miles*, 268 Fed., 692; Comment, 38 Mich. L. Rev., 526; Comment, 32 Ill. L. Rev., 223.)

The judgment of the circuit court of appeals is reversed.

The CHIEF JUSTICE and Mr. Justice ROBERTS think the judgment should be affirmed for the reasons stated in the opinion of the circuit court of appeals.

REGULATIONS 80 (1934), ARTICLE 25: Taxable insurance. 1941-11-10639 Ct. D. 1492

ESTATE TAX—REVENUE ACT OF 1926, AS AMENDED—DECISION OF SUPREME COURT.

1. GROSS ESTATE—INSURANCE—SINGLE PREMIUM POLICY AND ANNUITY CONTRACT PURCHASED BY UNINSURABLE.

Proceeds of a single premium life insurance policy purchased by decedent at the age of 74 in conjunction with a single premium annuity contract are not within the scope of section 302(g) of the Revenue Act of 1926, as amended, as amounts "receivable * * * as insurance." The case is not distinguishable from *Helvering* v. *Le Gierse*, decided on the same day [Ct. D. 1491, page 430, this Bulletin].

2. DECISION AFFIRMED.

Decision of the United States Circuit Court of Appeals, Third Circuit (1940) (113 Fed. (2d), 833), reversing decision of the United States Board of Tax Appeals (1939) (39 B. T. A., 1047), affirmed.

SUPREME COURT OF THE UNITED STATES.

Pius P. Keller, and Marcella V. Keller, petitioners, v. *Commissioner of Internal Revenue, respondent.*

[61 S. Ct. 651.]

On writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit.

[March 3, 1941.]

OPINION.

Mr. Justice MURPHY delivered the opinion of the Court.

This case is companion to No. 237, *Helvering* v. *Le Gierse*, decided this day [Ct. D. 1491, page 430, this Bulletin]. In all material respects the facts are alike except for the differences to be noted. Here the annuity contract provided for annual payments of $390.84 and cost decedent $3,258.20. The "insurance" policy stipulated for payment of $20,000 to decedent's daughter at decedent's death, and the single premium was $17,941.80. Decedent was 74 at the time the contract was executed and died about two years later. Proceeding on the same theory as in the Le Gierse case, the Commissioner assessed a deficiency in the Federal estate tax which the Board of Tax Appeals reversed. (39 B. T. A., 1047.) The circuit court of appeals in turn reversed the Board of Tax Appeals. (113 Fed. (2d), 833.) The case is here because of conflict with the Le Gierse case (110 Fed. (2d), 734). (311 U. S., —.)

Petitioners contend that this case is distinguishable from the Le Gierse case because here the insurance company found that the total consideration for the

two contracts, which was 106 per cent of the face value of the policy, was inadequate. They point out that the rate for this combination of contracts was later increased to 108 per cent and finally to 110 per cent. Further, they contend that absence of physical examination does not establish absence of risk, and that the Board of Tax Appeals found that there was "some" risk to the insurance company.

We find the distinctions insufficient to require a different result.

It is not enough to show that the insurance company assumed "some" risk. A bank assumes a risk when it accepts a depositor's funds and invests them. The investment may prove to be an unsafe one, or the bank may have agreed to pay the depositor a higher rate of interest than it can profitably earn on the funds it invests. Indisputably this is a risk. But it is not an insurance risk in the sense explained in the Le Gierse case. That the insurance company subsequently changed the total charge for this particular combination of contracts because it was unprofitable does not establish the existence of an insurance risk. Rather, it illustrates strikingly the interrelation of the two agreements and emphasizes the effort of the company to remove all possible investment risk.

Absence of a physical examination may well be inconclusive as to the existence of an insurance risk. For example, some companies do not require such an examination for group insurance. But there the risk as to one is distributed among the group, an insurance risk squarely within the definition stated in the Le Gierse case. Here the annuity issued with the policy did more than substitute for a physical examination. It removed the necessity for any risk distribution and completely countervailed a risk otherwise assumed in the "insurance" policy.

The finding by the Board of Tax Appeals that there was some risk necessarily is ambiguous in view of their finding that the company annually earned from 3½ to 4 per cent on its own investments. It is therefore reasonable to conclude that the "risk" referred to was a risk that the funds might not earn enough to cover profitably the annuity payable to the decedent, or a risk due to a miscalculation of the proper total consideration. In either event it is not a finding of the existence of an insurance risk.

Since the case is not distinguishable from *Helvering* v. *Le Gierse*, supra, the judgment of the circuit court of appeals is affirmed.

The CHIEF JUSTICE and Mr. Justice ROBERTS think the judgment should be reversed for the reasons stated in the opinion of the Circuit Court of Appeals for the Second Circuit in *Commissioner* v. *Le Gierse* (110 Fed. (2d), 734).

SECTION 302(j), AS ADDED BY SECTION 202(a) OF THE REVENUE ACT OF 1935.

REGULATIONS 80 (1937), ARTICLE 11: Optional valuation date. 1941–11–10640 Ct. D. 1494

ESTATE TAX—REVENUE ACTS OF 1926 AND 1935—DECISIONS OF SUPREME COURT.

1. GROSS ESTATE—OPTIONAL VALUATION—RENTS, DIVIDENDS, AND INTEREST RECEIVED DURING YEAR FOLLOWING DECEDENT'S DEATH.

Where an executor avails himself of the option extended by section 302(j) of the Revenue Act of 1926, as added by section 202(a) of the Revenue Act of 1935, to value a decedent's gross estate as of one year after the decedent's death, rents, dividends, and interest received during the year are not to be added to the value of the property to which they are attributable, for the purpose of determining the value of the gross estate as of the date one year after death.

2. VALIDITY OF REGULATIONS.

Article 11 of Regulations 80 (1937 edition) can not be sustained.

3. DECISIONS REVERSED.

Decisions of the United States Circuit Court of Appeals, Second Circuit (1940) (111 Fed. (2d), 78, and 114 Fed. (2d), 1017), reversed.

SUPREME COURT OF THE UNITED STATES.

No. 274. *Herbert H. Maass, as Sole Surviving Executor of the Last Will and Testament of Ida H. Saks, Deceased, petitioner,* v. *Joseph T. Higgins, Collector of Internal Revenue for the Third District of New York.*

No. 510. *Estate of Cordelia Y. Abendroth, City Bank Farmers Trust Co., as Executor of the Last Will and Testament of Cordelia Y. Abendroth, Deceased, petitioner,* v. *Commissioner of Internal Revenue.*

No. 511. *Estate of Kate Read Blacque, City Bank Farmers Trust Co., as Executor of the Last Will and Testament of Kate Read Blacque, Deceased, petitioner,* v. *Commissioner of Internal Revenue.*

[61 S. Ct., 631.]

On petitions for writs of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[March 3, 1941.]

OPINION.

Mr. Justice ROBERTS delivered the opinion of the Court.

In these cases we must decide whether, where an executor avails himself of the option extended by the estate tax law to value a decedent's gross estate as of one year after the decedent's death, rents, dividends, and interest received during the year are to be added to the value of the property to which they are attributable and included in the value of the gross estate. The question arises under section 302(j) of the Revenue Act of 1926 as added by section 202(a) of the Revenue Act of 1935.[1]

No. 274 is a suit against the collector to recover an overpayment of tax. The complaint alleged that the decedent died August 30, 1936; that in the estate's return the executors elected to have the value of the gross estate determined by valuing it as of one year after the decedent's death; that the Commissioner included in the estate a sum which was not in fact the decedent's property at the time of her death but represented income, namely, rents, dividends, and interest earned by the estate subsequent to the decedent's death; that the executors paid the tax and their claim for refund was rejected. The collector's answer raised no material issue of fact. Each party moved for judgment on the pleadings. The court dismissed the complaint.[2] The circuit court of appeals affirmed, one judge dissenting.[3]

In Nos. 510 and 511, the executor of two decedents who died respectively October 9, 1936, and April 3, 1937, elected in its returns to have the gross estates valued as of one year after death or as of date of disposition. In each case the executor collected interest and dividends upon bonds and stocks forming part of the estate at decedent's death. The sums so collected were not reckoned in fixing the values of the estates, except such portion of them as accrued prior to death. The Commissioner determined deficiencies due to the failure to return them. The Board of Tax Appeals affirmed his action[4] and the circuit court of appeals affirmed the Board's decision.[5]

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[1] The subsection has now been embodied in the Internal Revenue Code as section 811(j) (53 Stat., 122, 26 U. S. C. A., 811(j) and is in part as follows:

"OPTIONAL VALUATION.—If the executor so elects upon his return * * * the value of the gross estate shall be determined by valuing all the property included therein on the date of the decedent's death as of the date one year after the decedent's death, except that (1) property included in the gross estate on the date of death and, within one year after the decedent's death, distributed * * * or sold, exchanged, or otherwise disposed of, shall be included at its value as of the time of such distribution, sale, exchange, or other disposition, whichever first occurs, instead of its value as of the date one year after the decedent's death, and (2) any interest or estate which is affected by mere lapse of time shall be included at its value as of the time of death (instead of the later date) with adjustment for any difference in its value as of the later date not due to mere lapse of time. * * *"

[2] 29 Fed. Supp., 996.
[3] 111 Fed. (2d), 78.
[4] 41 B. T. A., 1178, four members dissenting.
[5] 114 Fed. (2d), 1017.

Although there was no conflict between decisions of circuit courts of appeals,[6] we granted certiorari because of the importance of the question and the number of pending cases in which it is presented.

It is agreed that the purpose of subdivision (j) was to mitigate the hardship consequent upon shrinkage in the value of estates during the year following death. Congress enacted it in the light of the fact that, due to such shrinkages, many estates were almost obliterated by the necessity of paying a tax on the value of the assets at the date of decedent's death. About one year after the adoption of the subsection, the Treasury promulgated article 11 of Regulations 80 (1937 edition) in which it ruled that interest bearing obligations, such as bonds, embodied two promises, one to pay principal, the other to pay interest, both a part of the gross estate if the obligation was owned by the decedent at his death. It further ruled that in the case of leased real estate two factors were to be considered, the value of the realty and the value of the covenant to pay rent. With respect to stocks, it ruled that the value of the stock and the value of the right to dividends thereon were separable and each constituted an element of value to the decedent. The regulation required that if, during the year subsequent to death, rents, royalties, interest, or dividends were received by the decedent's estate, such portion thereof as had not accrued, or was not attributable to a period, prior to death, should be returned in full and reckoned as part of the gross estate in any case where the executor elected, as permitted by subsection (j), to value the assets as of one year after the decedent's death or as of the date of disposition of any asset. In accordance with the regulation the deficiencies in the present cases were determined.

In the courts below, and before the Board of Tax Appeals, the Government contended that such items of income are in truth payments on account of principal and that, by such payments, the principal is reduced so that, when the capital asset is valued at the end of the period, its true value is not reflected unless there be added the interest, dividend, or other like payment received by the estate in the interim. In this Court, the argument takes a somewhat different form. Reference is made to the fact that, under the option granted, a capital asset is to be valued either at the expiration of the year or at the time of disposition and it is urged that, as respects interest, rent, or dividends, a disposition occurs at the date of the receipt of the item. In either aspect the validity of the contention depends upon the theory that, for purposes of estate tax valuation, the asset consists of two elements—one the right of ownership the other the right to receive the income. It is said that both of these elements enter into the valuation made as of the date of death and if, in the subsequent period, the latter emerges in the shape of a payment that payment is to be attributable to the income right rather than to the right of ownership of the income-producing property.

On the other hand, the petitioners insist that the Government's position is unreal and artificial; that it does not comport either with economic theory or business practice; and that the regulation is an unwarranted extension of the plain meaning of the statute and can not, therefore, be sustained. We hold that the petitioners are right.

It is not denied that, in common understanding, rents, interest, and dividends are income. Under the Revenue Acts, if such items are collected by a decedent's estate, the executors are bound to return them and pay tax upon them as income. In the case of a living holder, such receipts are never treated as on account of principal. Nor does the promise to pay interest, rents or dividends either to a living owner of the asset or to his executor after death, which has not been legally separated from the asset of which it is an incident, have any market value apart from the asset, or bear any invariable relation to the value of the capital asset.

It is true that a bond embodies two promises, one to pay the principal at maturity, the other to pay interest at intervals until maturity. And the promise to pay interest or rent, or the expectancy of dividends upon stock, the amount of such payments, the past and prospective regularity of the payments, and other elements bearing upon the expectation of the receipt of income affect the value of any income-producing property. But these elements are not separately valued in appraising the worth of the asset at any given time. It is the uniform practice to value the asset as an entirety, taking into consideration all the elements that go to give it value in the market.

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[6] The District Court for Maryland has decided contrary to the Circuit Court of Appeals for the Second Circuit: *Clark* v. *United States* (33 Fed. Supp., 216).

In the appraisal of a decedent's estate, rent or interest accrued to the date of death is properly treated as a capital asset. So also, on the sale of an interest bearing security, it is the uniform practice to add to the value of the obligation, as such, accrued interest to the date of sale. Since the statute says that, at the option of the executor, a bond may be valued as of one year subsequent to the decedent's death, the natural conclusion is that the usual method of valuation shall be pursued whichever date is selected. The method always adopted for valuation at death is the same used in fixing a sale price; that is, to take the market value of the bond and add accrued interest to the date of transfer, at the rate stipulated in the instrument. It is not believed that Congress, in providing for two dates of valuation, intended that a different method should be followed if one date were chosen rather than the other.

If Congress intended the result for which the Government contends, namely, that a different method of valuation should apply at the end of the 1-year period than that applicable as of the date of death, it would have been a simple matter so to state. That Congress had no such intention seems clear from the report of the House managers on the conference committee report on the bill which embodied the language in question.[7] There an example is given as to how the calculation of value should be made at the end of the year. In this example appreciation and depreciation in the value of bonds, stocks, and other assets, during the year, are shown but dividends or interest received are not included.

As has been said, the view we take comports with standard business practice; whereas the theory advocated by the Government involves the attribution to interest payments of a quality derived from a refined separation of so-called rights inherent in the ownership of income-producing property. Conceding that the ownership of a bond involves both the right to receive principal and the right to receive income, it is a highly artificial concept that an interest payment is a disposition, *pro tanto*, of the latter right by the owner of the obligation. Moreover, while the Constitution does not forbid double taxation, the intent to impose it upon a given receipt is not presumed. We think that, if it had been intended, Congress unequivocally would have so declared.

Judgments reversed.

Mr. Justice BLACK and Mr. Justice DOUGLAS are of the view that this question of statutory construction is peculiarly appropriate for administrative interpretation (see Paul, Studies in Federal Taxation (3d series), pages 423–425) and accordingly that the judgments in these cases should be affirmed for the reasons stated in the opinion of the court below in No. 274, *Saks* v. *Higgins* (111 Fed. (2d), 78).

[7] H. Rept. 1885, Seventy-fourth Congress, first session, pages 10–11 [C. B. 1939–1 (Part 2), 660].

GIFT TAX.

INTERNAL REVENUE CODE.

REGULATIONS 79 (1936), ARTICLE 2: Transfers reached. 1941-10-10632 T. D. 5041

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER B, PART 85.—GIFT TAX.

Article 2, Regulations 79 (1936 edition), amended.—Gifts of obligations of the United States by nonresident aliens not engaged in business in the United States.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

Article 2 of Regulations 79, 1936 edition [section 85.2, Title 26, Code of Federal Regulations], as made applicable to the Internal Revenue Code by Treasury Decision 4885, approved February 11, 1939 [C. B. 1939-1 (Part 1), 396] [Chapter I, note, of such Title 26, 1939 Sup.], is hereby amended by striking out the fourth sentence thereof reading as follows:

A gift of a bond, note, or certificate of indebtedness issued by the Federal Government, if made by a nonresident alien, not engaged in business in the United States, is not subject to the tax.—

and substituting in lieu thereof the following:

However, a gift of a bond, note, or certificate of indebtedness issued by the Federal Government prior to March 1, 1941, if made by a nonresident alien, not engaged in business in the United States, is not subject to the tax; but a gift by any such nonresident alien of an obligation of the Federal Government issued on or after March 1, 1941, is subject to the tax.

(This Treasury decision is issued under the authority contained in the following sections of law: Sections 1000, 1029, and 3791 of the Internal Revenue Code (53 Stat., 144, 157, 467 (26 U. S. C., Sup. V, 1000, 1029, 3791)).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved March 1, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register March 3, 1941, 3.52 p. m.)

TITLE III.—GIFT TAX. (1932)

SECTION 504(b).—NET GIFTS.

REGULATIONS 79 (1933), ARTICLE 10: Total amount of gifts. 1941-11-10641 Ct. D. 1493

GIFT TAX—REVENUE ACT OF 1932—DECISION OF SUPREME COURT.

1. GIFTS IN TRUST—SEPARATE EXEMPTION FOR EACH BENEFICIARY.

The donor of property in trust for the benefit of designated beneficiaries is entitled to a separate exemption of $5,000 for each

beneficiary, under the provisions of section 504(b) of the Revenue Act of 1932 and article 11 of Regulations 79 (1933 ed.).

2. DECISIONS AFFIRMED.

Decision of the United States Circuit Court of Appeals, Fifth Circuit (1940) (111 Fed. (2d), 229), reversing decision of the United States Board of Tax Appeals (1939) (40 B. T. A., 27), affirmed.

SUPREME COURT OF THE UNITED STATES.

Guy T. Helvering, Commissioner of Internal Revenue, petitioner, v. *Mary M. Hutchings.*

[61 S. Ct., 653.]

On writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

[March 3, 1941.]

OPINION.

Mr. Justice STONE delivered the opinion of the Court.

The petition for certiorari presents the single question whether under section 504(b) of the Revenue Act of 1932 (47 Stat., 169, 247), the donor of property in trust for the benefit of numerous beneficiaries is entitled to a single gift tax exemption or exclusion to the extent of the first $5,000 or to separate exemptions of $5,000 for each beneficiary.

Sections 501(a), 502(1) impose for each calendar year a tax on the net amount of the transfers "by any individual * * * of property by gift." By section 501(b) the tax applies "whether the transfer is in trust or otherwise" and "whether the gift is direct or indirect." In the computation of the tax laid upon "net gifts" made during the calendar year, section 504(b) provides "In the case of gifts (other than of future interests in property) made to any person by the donor during the calendar year the first $5,000 of such gifts * * * shall not * * * be included in the total amount of gifts made during such year." And section 1111, defining generally terms used throughout the Revenue Act, provides: "(a) When used in this Act—(1) The term 'person' means an individual, a trust or estate, a partnership, or a corporation."

On December 30, 1935, the taxpayer executed a trust indenture by which she transferred, in trust, property of a value of approximately $145,000 for a term ending in 1957, unless sooner terminated by the trustees, for the benefit of her seven children, with gifts over of the share of each child in event of the death of that child before the expiration of the trust. The taxpayer in her gift tax return for 1935 excluded from the taxable amount of her gifts the sum of $5,000 for each child or a total of $35,000. The Commissioner allowed only a single deduction of $5,000 in lieu of the seven $5,000 deductions claimed by the taxpayer and assessed a deficiency accordingly. The Board of Tax Appeals, treating the trust as the donee rather than the individual beneficiaries, sustained the Commissioner's assessment. The Court of Appeals for the Fifth Circuit reversed. (111 Fed. (2d), 229.) We granted certiorari October 28, 1940, to resolve a conflict of the decision below and of like decisions in other circuits. (*Welch* v. *Davidson*, 102 Fed. (2d), 100 (First Circuit); *Rheinstrom* v. *Commissioner*, 105 Fed. (2d), 642 (Eighth Circuit); *McBrier* v. *Commissioner*, 108 Fed. (2d), 967 (Third Circuit); and in the Court of Claims, *Pelzer* v. *United States*, 31 Fed. Supp., 770, with that of the Seventh Circuit in *Ryerson* v. *United States*, 114 Fed. (2d), 150.)

It is not doubted that separate gifts, other than of future interests, made directly to the donees without the intervention of a trustee entitle the donor under section 504(b), to one $5,000 exclusion for each gift. But the Government argues that here the trustee or the trust is the donee and as there was only a single trust there can be only a single statutory deduction from the total amount of the gifts. As the statute allows one deduction of the first $5,000 for each gift "made to any person" by the donor, the question for decision is whether in this case of a gift in trust for the benefit of the designated beneficiaries the single trust, or each beneficiary, is the "person" to whom the gift was made and for which the deduction is allowed.

The statutory definition of "person" in section 1111(a)(1) is of little aid in answering this question. The definition is made generally applicable to

all of the sections of the Revenue Act and was carried forward from earlier Acts which contained no gift tax provisions. (See section 2(a)(1) of the 1926 Revenue Act, 44 Stat., 9; section 701(a)(1) of the 1928 Revenue Act, 45 Stat., 878.) The section means no more than that the word "person" in any section of the Act in which it occurs may be taken as meaning "trust" rather than "individual" as the context may require. But section 504(b), allowing the deduction in the case of each gift to any person when applied to gifts in trust for designated beneficiaries, may be read as referring either to a gift to the trust or a gift to each individual beneficiary. Hence we must read the section in its setting of the gift tax provisions and in the light of its legislative history, to determine whether, within its meaning, the trust or each individual beneficiary is the donee to whom the gift is made.

The gift tax provisions are not concerned with mere transfers of legal title to the trustee without surrender by the donor of the economic benefits of ownership and his control over them. A gift to a trustee reserving to the donor the economic benefit of the trust or the power of its disposition, involves no taxable gift. It is only upon the surrender by the donor of the benefit or power reserved to himself that a taxable gift occurs (*Sanford's Estate* v. *Commissioner*, 308 U. S., 39 [Ct. D. 1426, C. B. 1939–2, 340]; *Rasquin* v. *Humphreys*, 308 U. S., 54 [Ct. D. 1425, C. B. 1939–2, 339]), and it would seem to follow that the beneficiary of the trust to whose benefit the surrender inures, whether made at the time the trust is created or later, is the "person" or "individual" to whom the gift is made.

But for present purposes it is of more importance that in common understanding and in the common use of language a gift is made to him upon whom the donor bestows the benefit of his donation. One does not speak of making a gift to a trust rather than to his children who are its beneficiaries. The reports of the committees of Congress used words in their natural sense and in the sense in which we must take it they were intended to be used in section 504(b) when, in discussing section 501, they spoke of the beneficiary of a gift upon trust as the person to whom the gift is made. Similarly they spoke of gifts effected by transfer of money or property to another as consideration for the payment of money or other property to a third person as a gift to the third person. (H. Rept. No. 708, Seventy-second Congress, first session, pages 27–28 [C. B. 1939–1 (Part 2), 457]; S. Rept. No. 665, Seventy-second Congress, first session, pages 39–40 [C. B. 1939–1 (Part 2), 496].) It is of some significance also that the denial by section 504(b) of the exemption in the case of gifts of "future interests" has little scope for practical operation unless the gifts to which the exemption applies include those gifts made to beneficiaries of a trust since it is by resort to the conveyance in trust that most future interests are created.

Moreover, the very purpose of allowing a gift tax exemption measured by the number of donees, would be defeated if a distinction were to be taken between gifts made directly to numerous donees and a gift made for their benefit by way of a single trust, and we are unable to discern in the statute or its legislative history any purpose to make such a distinction. While one object of the exemption was to permit small tax free gifts, and at the same time "to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts" without the necessity of keeping accounts and reporting the gifts (House Report, supra, 29; Senate Report, supra, 41), nevertheless the statute extended the exemption in the specified amount to all gifts, whether large or small, "made to any person."

In the face of an exemption thus made broadly applicable to all gifts to all donees and in the absence of some indication of an intention to discriminate between gifts made directly to the donees and those made indirectly to the beneficiaries of a trust, we can hardly assume a purpose to favor one class of donees over the other or find such a purpose in the words of the statutory definition of "person" which may indicate either the trust or each individual beneficiary of the trust as the person to whom the gift is made. Further, such an assumption would open the way to avoid the $5,000 limitation upon the allowed exemption, by resort to the simple expedient of the creation by a single donor of any number of trusts of $5,000 each for the benefit of a single beneficiary.[1] A construction so dependent upon an artificial meaning of the

[1] It was this construction of the statute by the Board of Tax Appeals and by "several of the Federal courts" which led to the amendment of section 504(b) so as to withdraw the exemption in the case of every gift in trust. (See section 505 of the 1938 Act, 52 Stat., 447. S. Rept. No. 1567, Seventy-fifth Congress, third session, page 41 [C. B. 1939–1 (Part 2), 779].)

words of the statute and so out of harmony with the statutory scheme and purpose is not to be favored.

Article 11 of Treasury Regulations 79 (1933 edition), issued under the 1932 Act treats each gift to the beneficiary of a trust as entitled to the benefit of the $5,000 deduction unless the gift is of a "future interest" which section 504(b) excepts from the exemption otherwise allowed. Such we think is the correct construction of the statute.

It is unnecessary to consider here the question whether a gift upon trust for impersonal, public or charitable purposes where there are no designated or ascertainable first beneficiaries is a gift to the trust entitled to a single $5,000 deduction. (See *Helvering* v. *Hutchings*, 111 Fed. (2d), 229, 231.) Nor do we consider whether the gifts to the beneficiaries here are of future interests which are excepted from the benefit of the $5,000 deduction allowed by section 504(b). That question is not presented by the petition for certiorari. But our judgment will be without prejudice to consideration of that question by the Board of Tax Appeals upon the remand to it if, under the rules and procedure governing proceedings before the Board, the Commissioner is free to present the question there.

Affirmed.

REGULATIONS 79 (1933), ARTICLE 11: Future interests in property. 1941-11-10642 Ct. D. 1495

GIFT TAX—REVENUE ACT OF 1932—DECISION OF SUPREME COURT.

1. GIFTS IN TRUST—"FUTURE INTERESTS IN PROPERTY."

Gifts made in trust for the benefit of the donor's then living grandchildren and any grandchildren thereafter born during the term of the trust, with directions to the trustee to accumulate the trust income for 10 years and then to pay the distributive share of income to each then living grandchild upon reaching 21 years of age, and with further directions for termination of the trust 21 years after the death of the last survivor of the named grandchildren, were gifts of "future interests in property" within the meaning of section 504(b) of the Revenue Act of 1932 and article 11 of Regulations 79, and are excluded from the benefits of that section.

2. DECISION REVERSED.

Decision of the Court of Claims (1940) (31 Fed. Supp., 770) reversed.

SUPREME COURT OF THE UNITED STATES.

The United States, petitioner, v. *Arthur Pelzer.*

[61 S. Ct., 659.]

On writ of certiorari to the Court of Claims.

[March 3, 1941.]

OPINION.

Mr. Justice STONE delivered the opinion of the Court.

Decision in this case turns on the question whether certain gifts of property in trust for the benefit of several beneficiaries are gifts of "future interests" which, in the computation of the gift tax, are, by section 504(b) of the 1932 Revenue Act (47 Stat., 169, 247), denied the benefit, otherwise allowed, of exclusion from the computation to the extent of the first $5,000 of each gift "made to any person by the donor" during the calendar year.

Sections 501(a) and 502(1) of the 1932 Act impose for each calendar year a tax upon the net amount of transfers "by any individual * * * of property by gift." For the purpose of computing the tax section 504(b) provides "In the case of gifts (other than of future interests in property) made to any person by the donor during the calendar year, the first $5,000 of such gifts * * * shall not * * * be included in the total amount of gifts made during such year."

In 1932 the taxpayer, respondent here, created a trust for the benefit of his eight grandchildren and any other grandchildren who might afterward be born during the term of the trust. The trustee was directed to accumulate the income for a period of 10 years and thereafter to pay an "equal grandchild's distributive share" of the income to each of the named grandchildren who were then living and 21 years of age and to pay a like share of income to each other named grandchild for life after that child should reach the age of 21 years. Provision was made whereby grandchildren born after the creation of the trust and during its life were to receive like participation in the income of the trust except as to distributions of income made prior to the birth of such after-born grandchildren, and except that the after-born grandchildren should be paid their shares of the income during their respective minorities after the termination of the 10-year accumulation period. The trust instrument also made gifts over of the share of the income of each grandchild at death, the details of which are not now material. It was further provided that the trust should terminate 21 years after death of the last survivor of the named grandchildren, when the corpus of the trust, with accumulated income, was to be distributed in equal shares among the surviving grandchildren and the issue *per stirpes* of all deceased grandchildren.

During the years 1933, 1934, and 1935, the taxpayer added further amounts of property to the 1932 trust. In 1934 he also made gifts directly to his three granddaughters and created a trust to pay the income in equal shares to his wife and three daughters with gifts over of each share of the corpus of the trust upon the death of the life tenant.

Upon claims for refunds of overpaid taxes upon the transfers made in the years 1933, 1934, and 1935, the Commissioner recomputed the tax and allowed one $5,000 exclusion only from the net amounts subject to gift tax given or added in each year to each trust. In the present suit, brought in the Court of Claims, respondent sought to recover overpaid taxes for the years in question on the grounds that the gifts to the beneficiaries were gifts of present not future interests and that the taxpayer in the computation of the tax for each year was entitled to one exclusion of $5,000 for each beneficiary. The court sustained both contentions and gave judgment for respondent accordingly. (31 Fed. Supp., 770.) We granted certiorari October 21, 1940, to resolve the conflict of the decision below with that of the Seventh Circuit in *Ryerson* v. *United States* (114 Fed. (2d), 150).

The Government challenges both grounds of decision below. It argues that only a single $5,000 exclusion is allowable under section 504(b) from the total gifts made to the trust in each calendar year and that if the gifts are deemed to be made to the named beneficiaries of the trust no deduction can be allowed in the case of gifts to the 1932 trust because they were of future interests for which no exclusion is allowed by section 504(b).

We have this day decided the first question, in No. 419, *Helvering* v. *Hutchings* [Ct. D. 1493, page 438, this Bulletin], in which we held that in the case of gifts in trust the beneficiaries are the persons to whom the gifts are made and that for purposes of computation of the tax section 504(b) excludes the first $5,000 in value of the gift to each beneficiary from the taxable amount of the gifts made in the calendar year. For the reasons stated in our opinion in that case we hold that the first beneficiaries of the trusts in this case are the persons to whom the gifts were made and that the taxpayer is entitled to the benefit of the $5,000 exclusion for each gift to such beneficiary if it is not of a future interest.

But the Government argues here, as it did below, that the gifts to the beneficiaries of the 1932 trust are of future interests within the meaning of the statute and Treasury regulations. While the eight named grandchildren are the first beneficiaries of the trust, and the persons to whom the gifts were made, none of them takes any benefit from the trust before the end of the 10-year accumulation period or until he is 21, whichever last occurs, and then only if he survives that event. And the question is whether such a gift is a gift of a "future interest" within the meaning of section 504(b). Respondent, relying on statutes and judicial decisions of Alabama, where the trust was created and is being administered, insists that the gifts to the named grandchildren are present not future interests as defined by Alabama law. He argues that as section 504(b) does not define the "future interests" gifts of which are excluded from its benefits, they must be taken to be future interests as defined by the local law, and it is the local law definition of future interests which must be adopted in applying the section. But as we have often had occasion to point out, the revenue laws are to be construed in the light of their general purpose to establish a Nation-wide scheme of taxation uniform in its application. Hence their provisions are not to be taken as subject to State control

or limitation unless the language or necessary implication of the section involved makes its application dependent on State law. (*Burnet* v. *Harmel*, 287 U. S., 103, 110; *Morgan* v. *Commissioner*, 309 U. S., 78, 81.)

We find no such implication in the exclusion of gifts of "future interests" from the benefits given by section 504(b). In the absence of any statutory definition of the phrase we look to the purpose of the statute to ascertain what is intended. It plainly is not concerned with the varying local definitions of property interests or with the local refinements of conveyancing, and there is no reason for supposing that the extent of the granted tax exemption was intended to be given a corresponding variation. Its purpose was rather the protection of the revenue and the appropriate administration of the tax immunity provided by the statute. It is this purpose which marks the boundaries of the statutory command. The committee reports recommending the legislation declared (H. Rept. No. 708. Seventy-second Congress, first session, page 29 [C. B. 1939–1 (Part 2), 457]; S. Rept. No. 665, Seventy-second Congress, first session, page 41 [C. B. 1939–1 (Part 2), 496]):

"The term 'future interests in property' refers to any interest or estate, whether vested or contingent, limited to commence in possession or enjoyment at a future date. The exemption being available only in so far as the donees are ascertainable, the denial of the exemption in the case of gifts of future interests is dictated by the apprehended difficulty, in many instances, of determining the number of eventual donees and the values of their respective gifts."

Article 11 of Treasury Regulations 79, 1933 and 1936 editions, interpreting section 504(b), declared that "future interests" include any interest or estate "whether vested or contingent, limited to commence in use, possession, or enjoyment at some future date or time." This definition stands unchanged in the regulations and while section 504(b) was amended by section 505 of the 1938 Revenue Act so as to withdraw the benefit of the $5,000 exclusion from all gifts in trust the section as amended continues to withhold the benefit of the exclusion from all gifts of "future interests in property."

We think that the regulations, so far as they are applicable to the present gifts, are within the competence of the Treasury in interpreting section 504(b) and effect its purpose as declared by the reports of the Congressional committees, and that the gifts to the eight beneficiaries of the 1932 trust were gifts of future interests which are excluded from the benefits of that section. Here the beneficiaries had no right to the present enjoyment of the corpus or of the income and unless they survive the 10-year period they will never receive any part of either. The "use, possession, or enjoyment" of each donee is thus postponed to the happening of a future uncertain event. The gift thus involved the difficulties of determining the "number of eventual donees and the value of their respective gifts" which it was the purpose of the statute to avoid.

We have no occasion to consider the definition of future interests in other aspects than those presented by the present case. The judgment of the court of appeals will be reversed so far only as it excluded the gifts to the 1932 trust from the computation of the tax for each of the years in question.

Reversed.

REGULATIONS 79 (1933), ARTICLE 11: Future interests in property. 1941-11-10643 C. D. 1496

GIFT TAX—REVENUE ACT OF 1932—DECISION OF SUPREME COURT.

1. GIFTS IN TRUST—"FUTURE INTERESTS IN PROPERTY."

Gifts of trust income to a life tenant with remainder over to remaindermen for life conditioned upon survivorship, gifts of a separate equal share of corpus to each of two trustees in the event of their joint requests that the trust be terminated, and gifts of corpus to descendants of deceased son of the grantor conditioned upon survivorship, are gifts of "future interests" within the meaning of section 504(b) of the Revenue Act of 1932 and article 11 of Regulations 79, and are excluded from the benefits of that section.

2. DECISION AFFIRMED.

Decision of the United States Circuit Court of Appeals, Seventh Circuit (1940) (114 Fed. (2d), 150), affirmed.

SUPREME COURT OF THE UNITED STATES.

Joseph Ryerson and Edward L. Ryerson, Jr., as Executors of the Estate of Mary M. Ryerson, petitioners, v. *The United States of America.*

[61 S. Ct., 656.]

On writ of certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.

[March 3, 1941.]

OPINION.

Mr. Justice STONE delivered the opinion of the Court.

This is a companion case to No. 419, *Helvering* v *Hutchings* [Ct. D. 1493, page 438, this Bulletin], and No. 393, *United States* v. *Pelzer* [Ct. D. 1495, page 441, this Bulletin], decided this day, and it presents the questions decided in those cases.

The sole question raised by the petition for certiorari is whether, under section 504(b) of the Revenue Act of 1932 (47 Stat., 169, 247), the donor of property in trust for numerous beneficiaries is entitled to a single gift tax exemption or exclusion to the extent of the first $5,000 of the gift or to separate exemptions of $5,000 for each beneficiary. The Government insists that if that question be decided against it, it is nevertheless entitled to retain the judgment below in its favor because the gifts to the beneficiaries were of future interests which, by section 504(b), are denied the benefit of the exclusion otherwise allowed by the section.

In 1934 petitioners' testatrix transferred two single premium insurance policies on her own life maturing at a future date, as additions to two separate trusts, one created in 1933, the other established in 1934 but before the transfer. The instrument creating the first trust provided that the trustees should pay over one-fourth of the net income to Mary Ryerson Frost, one of the trustees, for life, with remainder over for life to her two daughters if surviving at her death, with further remainders over to their issue *per stirpes*. The trust instrument directed that the remaining three-fourths of the income should be accumulated and added to the principal of the trust. It provided that the trust was to terminate upon the death of the last survivor of three persons, the first life tenant and her two daughters, and was then to be distributed, the particular distribution being dependent upon contingencies which are not now material. The trust instrument also contained numerous provisions for the termination of the trust by joint action of the trustees, Donald McKay Frost and Mary Ryerson Frost, who was also life tenant, or by the survivor of either of them in the case of the death or mental incapacity of either. Other provisions were made for the termination of the trust and distribution of the trust property in the event of the death or mental incapacity of both, without having exercised their power of termination.

The instrument creating the 1934 trust provided that upon the death of the grantor, who was the insured, who was living at the time of the transfer, the trustees should distribute the proceeds of the insurance as follows: If the widow of the grantor's son survived the grantor the income of one-third of the proceeds of the insurance policy was to be paid to the son's widow for life with remainders over to those persons who would be heirs at law of the son had he died at the same time as the life tenant. The remaining two-thirds of the proceeds or all if the son's widow did not survive the grantor, were to go to the descendants of the grantor's son then surviving, with gifts over in default of such descendants.

In a suit brought by petitioner to recover overpaid gift taxes for the year 1934 the district court ruled that in the computation of the tax the taxpayer was entitled to two exclusions to the extent of $5,000 each for the gifts made to Mary Ryerson Frost and Donald McKay Frost under the 1933 trust and to three exclusions under the 1934 trust, one for the son's widow and two for his two living descendants. The Court of Appeals for the Seventh Circuit reversed (114 Fed. (2d), 150), holding that the two trusts were the donees and that a single exclusion was allowable for each trust. We granted certiorari November 12, 1940, to resolve the conflict between the decision below and that of the circuit courts of appeals in the Pelzer case and the Hutchings case.

For the reasons stated in our opinion in the Hutchings case we hold that the beneficiaries of the two trusts were the persons to whom the gifts were made and that the gifts to them and not to the trusts, as the courts below held, were entitled to the benefit of the exclusion allowed by section 504(b) provided the gifts were not of "future interests" to which the section denies the benefit of the exclusion.

As the Government has not sought certiorari it can not attack the judgment below, but it is free to sustain it upon any legal ground which will support it. (*LeTulle* v. *Scofield*, 308 U. S., 415, 421, 422.) Even though the judgment below was rested upon the erroneous ground that the trusts were "persons" to whom the gifts were made within the meaning of section 504(b), the Government may justify the judgment here on the ground that petitioners are not entitled to the exclusions claimed so far as the gifts were of future interests.

The gifts of a separate equal share of the corpus of the 1933 trust to each of the two trustees in the event of their joint request that the trust be terminated was a gift upon a contingency which might never happen. For the reasons stated in our opinion in the Pelzer case those gifts were of future interests within the meaning of section 504(b) and consequently were not entitled to the benefit of the exclusion. While a present power of disposition for one's own benefit is the equivalent of ownership (see *Curry* v. *McCandless*, 307 U. S., 357, 370, *et seq.*, and cases cited), here the joint power was not for the joint benefit of the donees of the power. Its exercise could only operate for the benefit of each to the extent of one-half of the trust property and then only in the event that both agreed to unite in its exercise. In any case use and enjoyment of any part of the trust fund by either was postponed until such time as both joined in the exercise of the power. The interests granted to the trustees upon their termination of the trust should therefore have been included to their full extent in the computation of the gift tax because they were "future interests" within the meaning of section 504(b) and article 11, Treasury Regulations 79. As the petitioners have been allowed one exclusion by the judgment below which is not attacked here it is unnecessary to consider whether the life interest in the income given to Mary Ryerson Frost is a present or future interest within the meaning of section 504(b).

For like reasons we conclude that the gifts to the beneficiaries of the 1934 trust were of future interests and that the petitioners are entitled to no exclusion with respect to them. The gift of income to the life tenant was contingent upon her survivorship of the grantor at a future date. The gifts of the principal amount of the proceeds of the policy to descendants of the deceased son of the grantor were in part contingent upon their survivorship of the son's widow and her survivorship of the grantor or, if she did not survive him, then the gifts of the entire principal were contingent upon survivorship of the descendants at the grantor's death. Thus all those who might become entitled to the use and enjoyment of the trust, principal and income, were ascertainable only upon the happening of one or more uncertain future events, survivorship of one or more persons at the death of the donor, and so they were donees of gifts of "future interests" within the meaning of section 504(b) and the Treasury regulations. Consequently petitioners are not entitled to the single exclusion which the court below allowed. But because the Government has sought no cross-petition attacking the judgment below, it must be affirmed.

SECTION 506.—GIFTS MADE IN PROPERTY.

REGULATIONS 79 (1933), ARTICLE 19: Valuation of property. 1941–7–10599 Ct. D. 1487

GIFT TAX—REVENUE ACT OF 1932—DECISION OF SUPREME COURT.

1. SINGLE PREMIUM LIFE INSURANCE POLICIES—VALUE AT DATE OF GIFT—APPLICABILITY OF REGULATIONS.

The "value" at the date of the gift of single premium life insurance policies which were irrevocably assigned simultaneously with issuance, in 1934, is cost to the donor rather than cash surrender value, under the provisions of section 506 of the Revenue Act of 1932. Article 2(5), Regulations 79, in effect at the time of the gift, is not applicable to single premium policies.

2. DECISION AFFIRMED.

Decision of the United States Circuit Court of Appeals, Second Circuit (1940) (110 Fed. (2d), 371), affirmed.

SUPREME COURT OF THE UNITED STATES.

Florence Guggenheim, petitioner, v. *Martha E. Rasquin, Administratrix of the Estate of Almon Q. Rasquin, Deceased.*

[312 U. S., 254.]

On writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[February 3, 1941.]

OPINION.

Mr. Justice DOUGLAS delivered the opinion of the Court.

It is provided in the Revenue Act of 1932 (47 Stat., 169, 248) that for gift tax purposes the amount of a gift of property shall be "the value thereof at the date of the gift." (Section 506.) This controversy involves the question of whether such "value" in case of single premium life insurance policies, which are irrevocably assigned simultaneously with issuance, is cost to the donor or cash surrender value of the policies. The case is here on a petition for certiorari which we granted because of a conflict among the circuit courts of appeals[1] as respects the proper method for valuation of such gifts made prior to 1936.[2]

In December, 1934, petitioner purchased, at a cost of $852,438.50, single premium life insurance policies on her own life in the aggregate face amount of $1,000,000. At substantially the same time she assigned them irrevocably to three of her children. Her gift tax return listed the policies at their asserted cash surrender value[3] of $717,344.81. The Commissioner determined that the "value" of the policies was their cost and assessed a deficiency which petitioner paid. This is a suit for a refund. Judgment for petitioner in the district court was reversed by the circuit court of appeals. (110 Fed. (2d), 371.)

We agree with the circuit court of appeals that cost rather than cash surrender value is the proper criterion for valuation of such gifts under section 506 of the Act.

Cash surrender value is the reserve less a surrender charge. And in case of a single premium policy the reserve is the face amount of the contract discounted at a specified rate of interest on the basis of the insured's expected life. If the policy is surrendered, the company will pay the cash surrender value. It is asserted that the market for insurance contracts is usually the issuing companies or the banks who will lend money on them; that banks will not loan more than the cash surrender value; and that if policies had an actual realizable value in excess of their cash surrender value, there would arise a business of purchasing such policies from those who otherwise would surrender them. From these facts it is urged that cash surrender value represents the amount which would be actually obtained for the policies in a willing buyer–willing seller market—the test suggested by Treasury Regulations 79, article 19(1), promulgated October 30, 1933.[4]

That analysis, however, overlooks the nature of the property interest which is being valued. Surrender of a policy represents only one of the rights of the insured or beneficiary. Plainly that right is one of the substantial legal incidents of ownership. (See *Chase National Bank* v. *United States*, 278 U. S., 327, 335 [Ct. D. 40, C. B. VIII–1, 308 (1929)]; Vance on Insurance (2d ed.), 54–56.) But

[1] In conflict with the decision below are *Commissioner* v. *Haines* (104 Fed. (2d), 854 (C. C. A. 3)); *Helvering* v. *Cronin* (106 Fed. (2d), 907 (C. C. A. 8)); *United States* v. *Ryerson* (114 Fed. (2d), 150 (C. C. A. 7)), discussed in Paul, Studies in Federal Taxation (3d series), pages 403 *et seq.*

[2] Article 19(9), Treasury Regulations 79, promulgated February 26, 1936, provides that replacement cost at the date of the gift is the measure of value of a single premium life insurance policy.

[3] The Government asserts that none of the policies had a cash surrender value prior to the expiration of one year. In view of our disposition of the case we do not stop to decide whether, in view of the pleadings and the stipulation, that position can be maintained here.

[4] Article 19(1) provided: "* * * The value of property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell. Where the property is sold within a reasonable period after the date of the gift, and it is shown that the selling price reflects the fair market value thereof as of the date of the gift, the selling price will be accepted as the amount of the gift. All relevant facts and elements of value should be considered in every case."

the owner of a fully paid life insurance policy has more than the mere right to surrender it; he has the right to retain it for its investment virtues and to receive the face amount of the policy upon the insured's death. That these latter rights are deemed by purchasers of insurance to have substantial value is clear from the difference between the cost of a single premium policy and its immediate or early cash surrender value—in the instant case over $135,000. All of the economic benefits of a policy must be taken into consideration in determining its value for gift tax purposes. To single out one and to disregard the others is in effect to substitute a different property interest for the one which was the subject of the gift. In this situation as in others (*Susquehanna Power Co.* v. *State Tax Commission*, 283 U. S., 291, 296) an important element in the value of the property is the use to which it may be put. Certainly the petitioner here did not expend $852,438.50 to make an immediate gift limited to $717,344.81. Presumptively the value of these policies at the date of the gift was the amount which the insured had expended to acquire them. Cost is cogent evidence of value. And here it is the only suggested criterion which reflects the value to the owner of the entire bundle of rights in a single premium policy—the right to retain it as well as the right to surrender it. Cost in this situation is not market price in the normal sense of the term. But the absence of market price is no barrier to valuation.[6] (*Lucas* v. *Alexander*, 279 U. S., 573, 579 [Ct. D. 76, C. B. VIII–2, 273 (1929)].)

Petitioner, however, argues that cash surrender value was made the measure of value by article 2(5), Treasury Regulations 79, promulgated October 30, 1933, which provided that the "irrevocable assignment of a life insurance policy * * * constitutes a gift in the amount of the net cash surrender value, if any, plus the prepaid insurance adjusted to the date of the gift." The argument is that under this regulation the reserve in case of a single premium policy covers the prepaid insurance and represents the entire value of the policy. The regulation is somewhat ambiguous. But in our view it applied only to policies upon which current premiums were still being paid at the date of the gift, not to single premium policies. Accordingly, the problem here involves an interpretation of the meaning of "value" in section 506 unaided by an interpretative regulation.

Affirmed.

REGULATIONS 79 (1933), ARTICLE 19: Valuation of property.

1941–7–10600
Ct. D. 1488

GIFT TAX—REVENUE ACT OF 1932—DECISION OF SUPREME COURT.

1. SINGLE PREMIUM LIFE INSURANCE POLICIES—VALUE AT DATE OF GIFT.

The "value," for gift tax purposes, of single premium life insurance policies taken out by the insured in 1928 and 1929, and assigned as gifts in 1934, is the cost of replacement of the policies at the dates of the gifts. The elapse of time between issuance and assignment of the policies does not justify the substitution of cash surrender value for replacement cost as the criterion of value.

2. DECISION REVERSED.

Decision of the United States Circuit Court of Appeals, Seventh Circuit (1940) (114 Fed. (2d), 150), reversed.

SUPREME COURT OF THE UNITED STATES.

The United States of America, petitioner, v. *Joseph T. Ryerson and Edward L. Ryerson, Jr., as Executors of the Estate of Mary M. Ryerson.*

[312 U. S., 260.]

On writ of certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.

[February 3, 1941.]

OPINION.

Mr. Justice DOUGLAS delivered the opinion of the Court.

The question here is the same as that in *Guggenheim* v. *Rasquin*, No. 92 [Ct. D. 1487, page 445, this Bulletin] decided this day. Consequently the decision of the

[6] In this connection it should be noted that article 19(1), supra, note 4, did not establish market price as the sole criterion of value.

circuit court of appeals holding that cash surrender value on the dates of the gifts was the proper method of valuing single premium life insurance policies for gift tax purposes (114 Fed. (2d), 150) must be reversed, unless the elapse of time between the issuance of the policies and the making of the gifts calls for a different result. The single premium policies here involved were taken out by the insured in 1928 and 1929. They were assigned as gifts in December, 1934, when the insured was 79 years old. The cost of the policies was less than their cash surrender value at the dates of the gifts. But the cost of replacing the policies at the then age of the insured would have been in excess of their cash surrender value. We think that such cost of replacement, as held by the district court, is the best available criterion of the value of the policies for the purposes of the gift tax. The elapse of time between issuance and assignment of the policies does not justify the substitution of cash surrender value for replacement cost as the criterion of value. We can not assume with respondents that at the dates of the gifts the policies presumably had no insurance, as distinguished from investment value to the donor. Here, as in the case where the issuance of the policies and their assignment as gifts are simultaneous, cash surrender value reflects only a part of the value of the contracts. The cost of duplicating the policies at the dates of the gifts is in absence of more cogent evidence the one criterion which reflects both their insurance and investment value to the owner at that time. (Cf. Vance on Insurance (2d ed.), 332–333; *Speer* v. *Phoenix Mutual Life Ins. Co.*, 36 Hun., 322.) The fact that the then condition of an insured's health might make him uninsurable emphasizes the conclusion that the use of that criterion will result in placing a minimum value upon such a gift.

Reversed.

Regulations 79 (1933), Article 19: Valuation of property.

1941–7–10601
Ct. D. 1489

GIFT TAX—REVENUE ACT OF 1932—DECISION OF SUPREME COURT.

1. Single Premium Life Insurance Policies—Value at Date of Gift—Question of Law.

The "value," for gift tax purposes, of single premium life insurance policies, purchased and irrevocably assigned as gifts in 1935, is the cost of duplicating them at the dates of the gifts rather than the cash surrender value. The question of what criterion should be employed for determining the value of the gifts is a question of law, and the court below was justified in substituting its judgment of value for that of the Board.

2. Decision Affirmed.

Decision of the United States Circuit Court of Appeals, First Circuit (1940) (115 Fed. (2d), 209), reversing unreported decision of the United States Board of Tax Appeals, affirmed.

Supreme Court of the United States.

Madeleine D. Powers, petitioner, v. *Commissioner of Internal Revenue.*
[312 U. S., 259.]

On writ of certiorari to the United States Circuit Court of Appeals for the First Circuit.

[February 3, 1941.]

OPINION.

Mr. Justice Douglas delivered the opinion of the Court.

The issue in this case is the same as that in *Guggenheim* v. *Rasquin*, No. 92 [Ct. D. 1487, page 445, this Bulletin], decided this day. Petitioner in November and December, 1935, purchased single premium policies of insurance on her own life and late in December, 1935, irrevocably assigned them as gifts. The Com-

missioner determined a deficiency, claiming that the value of the policies for gift tax purposes was the cost of duplicating them at the dates of the gifts, not the cash surrender value as reported by petitioner. The Board of Tax Appeals held that the value of the gifts was their cash surrender value. The circuit court of appeals reversed. (115 Fed. (2d), 209.) That judgment must be affirmed on the authority of *Guggenheim* v. *Rasquin*, supra, unless as claimed by petitioner the court below was precluded from substituting its judgment of value for that of the Board. (*Helvering* v. *Rankin*, 295 U. S., 123, 131 [Ct. D. 966, C. B. XIV–1, 160 (1935)].) But the question of what criterion should be employed for determining the "value" of the gifts is a question of law. (See *Lucas* v. *Alexander*, 279 U. S., 573 [Ct. D. 76, C. B. VIII–2, 273 (1929)].) Accordingly, the circuit court of appeals was justified in reversing the decision of the Board as "not in accordance with law." (Internal Revenue Code, 1939, section 1141(c)(1); 53 Stat., 164.)

Affirmed.

TITLE IV.—MANUFACTURERS' EXCISE TAXES. (1932)

SECTION 603.—TOILET PREPARATIONS, ETC.

REGULATIONS 46 (1932), ARTICLE 22: Scope of tax. 1941–6–10592
Ct. D. 1485

MANUFACTURERS' EXCISE TAX—REVENUE ACT OF 1932—DECISION OF COURT.

1. TAX ON TOILET PREPARATIONS—MECHANICS' HAND PASTE—SIMILAR TO TOILET SOAP.

A product described as a mechanics' hand paste, manufactured and sold under the name of "Mione," is a substance similar to toilet soap, is principally used and intended to be used for toilet purposes, and is therefore subject to the tax imposed by section 603 of the Revenue Act of 1932.

2. INCONSISTENT POSITIONS.

Since the manufacturer advertised its product for use as a toilet soap, it is not in a position to deny that it is a toilet soap within the meaning of the taxing statute.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

The Mione Manufacturing Co., plaintiff-appellant, v. *The United States of America, defendant-appellee.*

The Mione Manufacturing Co., plaintiff-appellant, v. *Walter J. Rothensies, Collector of Internal Revenue for the First District of Pennsylvania, defendant-appellee.*

[114 Fed. (2d), 647.]

Appeals from the District Court of the United States for the Eastern District of Pennsylvania.

[September 6, 1940.]

OPINION.

GOODRICH, Circuit Judge: Appellant, plaintiff below, instituted these two actions to recover excise taxes paid upon its product, "Mione." The questions being the same except for the year involved, the actions were consolidated and tried by the court below without a jury. The trial court found against the plaintiff. The applicable statute is the Revenue Act of 1932 (ch. 209, section 603, 47 Stat., 261).[1]

Plaintiff's product which it describes as a "mechanics' hand paste," is a gray paste of the following composition:

	Per cent.
Abrasive (pumice)	20.43
Soap chips	6.88
Alkaline salts	1.50
Oil of camphor sassafrassy	.19
Water	71.00

[1] There is hereby imposed upon the following articles, sold by the manufacturer, producer, or importer, a tax equivalent to 10 per centum of the price for which so sold: Perfumes, essences, extracts, toilet waters, cosmetics, petroleum jellies, hair oils, pomades, hair dressings, hair restoratives, hair dyes, tooth and mouth washes (except that the rate shall be 5 per centum), dentifrices (except that the rate shall be 5 per centum), tooth pastes (except that the rate shall be 5 per centum), aromatic cachous, toilet soaps (except that the rate shall be 5 per centum), toilet powders, and any similar substance, article, or preparation, by whatsoever name known or distinguished; any of the above which are used or applied or intended to be used or applied for toilet purposes.

It is found by the trial court that the product is not a toilet soap,[2] and the sole question for decision now is whether it is a "similar substance, article or preparation * * * used or applied or intended to be used or applied for toilet purposes."

The court below found that Mione is similar to toilet soap in chemical composition, some physical characteristics and in use, but that it is not generally in commercial competition with toilet soaps in that "it is intended to perform the heavier kinds of the same general functions, of which the toilet soaps perform the lighter and finer." The court concluded that Mione was a "similar substance, article or preparation" to toilet soap. It was also found that the preparation is principally used and intended to be used for toilet purposes, although it is also used and intended to be used to some extent as a general household cleaner.

Appellant's argument is based on three grounds. It is contended first that under the statute two tests must be met for tax liability: (*a*) the object taxed must either be, or be similar to, one of the enumerated articles, and (*b*) it must be used or intended to be used for toilet purposes. Second, that the finding of the court below that Mione is similar to toilet soap is unsupported by the evidence. Third, that the same is true with respect to the finding that Mione is used for toilet purposes.

The first and the last point are easily disposed of. As to the first, it seems clear that the appellant is correct on the construction of the statute and that both tests have to be met. As to the third, there is no doubt that Mione is used for toilet purposes. The removal of grease and grime from the hands is no less a toilet function than the removal of dust or tobacco. Even if we accept plaintiff's contention that the connotation of "toilet" is to be limited to making the person more alluring, certainly simple cleanliness is a sine qua non of such allure. It is immaterial that the soap may be used for other purposes, for the statute does not require that the toilet purpose be the sole one. For example, it is common knowledge that toilet soaps in the strict sense may be and are used for laundry purposes. There is nothing in *McCaughn* v. *Electric Storage Battery Co.* (63 Fed. (2d), 715 (C. C. A. 3, 1933)) requiring a different conclusion.

The more perplexing question in the case involves the determination of what is a "similar substance, article or preparation" to toilet soap. *Sharp & Dohme, Inc.*, v. *Ladner* (82 Fed. (2d), 733 (C. C. A. 3, 1936) [Ct. D. 973, C. B. XIV–1, 407 (1935)]) is of no assistance here for that case went upon the ground that the item sought to be taxed did not come within the phrase "used or applied or intended to be used or applied for toilet purposes." In *Duradene Co., Inc.*, v. *Magruder* (21 Fed. Supp., 426 (D. C. Md., 1937), affirmed per curiam, 95 Fed. (2d), 999 (C. C. A. 4, 1938), the court, in determining whether a certain hair preparation was subject to tax, spoke of similarity in composition and in use. *Flash Chemical Co.* v. *United States* (23 Fed. Supp., 440 (Ct. of Claims, 1938)) involved the taxability of a soap like Mione and in direct competition with it. The court there spoke of similarity "in substance," and upheld the imposition of the tax.

Whether one thing is similar to another depends of course on the particular properties being compared. Thus iron and mercury are similar in that they are both metals, but they are dissimilar in that one is a solid and the other a liquid at ordinary temperatures. Plaintiff points to various dissimilarities between Mione and toilet soap. It is not similar in feel, texture or appearance to toilet soap; its function is performed to a large extent by the mechanical action of the abrasive, absent in toilet soap; its chemical composition also differs from toilet soap in the amount of alkaline salts present and the ratio of the various ingredients. But we think there are sufficient points of identity to sustain the holding of the court below. Both Mione and toilet soap *do* contain anhydrous soap, alkaline salts and water; both employ an agent to impart a pleasant odor to the product; both produce a lather, and, most important, they are designed to perform the same principal function, viz, cleansing of the body.

Under the wording of the statute principal use seems to us important in determining similarity. Furthermore, the plaintiff's advertisements of its product

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[2] A typical toilet soap, according to the testimony for the plaintiff in the court below, would be composed as follows:

	Per cent.
Anhydrous soap	60 to 85
Alkaline salts	0. 3 to 1. 5
Abrasives	None.

Desired perfumes are added, glycerin is sometimes included and the balance is composed of water.

contain phrases such as: "leaves the hands soft and white"; "kiddies like it * * * and its fine cleansing and softening oils are good for their tender skin"; "keeps hands dainty."; "protects delicate skin"—all typical claims generally made for toilet soaps. As was said in *Red Star Yeast & Products Co.* v. *La Budde* (83 Fed. (2d), 394, 396 (C. C. A. 7, 1936) [Ct. D. 1132, C. B. XV–1, 389 (1936)]), "The district court could hardly be expected to find that the product was not what appellant said it was in its advertisements." (See also *Peroxide Chemical Co.* v. *Sheehan*, 108 Fed. (2d), 306, 308 (C. C. A. 8, 1939).) *We think the plaintiff can hardly be allowed to tell one story to prospective customers and a different story to the tax collector.* [Italics supplied.]

The judgment of the district court is affirmed.

REGULATIONS 46 (1932), ARTICLE 22: Scope of tax. (Also Section 619 and Article 10.)

1941–25–10752
Ct. D. 1519

MANUFACTURERS' EXCISE TAX—REVENUE ACT OF 1932—DECISION OF COURT.

TAX ON TOILET PREPARATIONS—SALES PRICE—SALES MADE THROUGH WHOLLY-OWNED SUBSIDIARY—SELLING AND ADVERTISING COSTS TO BE INCLUDED IN DETERMINING SALES PRICE.

For the purposes of the manufacturers' excise tax imposed by section 603 of the Revenue Act of 1932, the charge at which products are transferred by a manufacturer to his wholly-owned subsidiary is not a proper basis for the tax where such subsidiary is a mere agent wholly controlled by the parent. Manufacturers' selling and advertising expenses are not to be excluded in determining the sale price to which the tax is applicable, and the action of Congress in amending section 603 of the Revenue Act of 1932 by section 3 of the Revenue Act of 1939 confirms this view.

COURT OF CLAIMS OF THE UNITED STATES.

The Ayer Co. v. *The United States.*

[38 F. Supp., 284.]

[April 7, 1941.]

OPINION.

WHITAKER, Judge, delivered the opinion of the court.

The facts are fully set out in the findings of fact. The question presented is the proper basis for the tax on plaintiff's sales of cosmetics imposed by section 603 of the Revenue Act of 1932 (47 Stat., 261). This section reads in part:

"There is hereby imposed upon the following articles, sold by the manufacturer, producer, or importer, a tax equivalent to 10 per centum of the price for which so sold: Perfumes, essences, extracts, toilet waters, cosmetics, * * *."

Section 619 set out the formula for determining the sales price. It reads:

"SEC. 619. SALE PRICE.

"(a) In determining, for the purposes of this title, the price for which an article is sold, there shall be included any charge for coverings and containers of whatever nature, and any charge incident to placing the article in condition packed ready for shipment, but there shall be excluded the amount of tax imposed by this title, whether or not stated as a separate charge. A transportation, delivery, insurance, installation, or other charge (not required by the foregoing sentence to be included) shall be excluded from the price only if the amount thereof is established to the satisfaction of the Commissioner, in accordance with the regulations.

"(b) If an article is—

"(1) sold at retail;

"(2) sold on consignment; or

"(3) sold (otherwise than through an arm's-length transaction) at less than fair market price;

the tax under this title shall (if based on the price for which the article is sold) be computed on the price for which such articles are sold, in the ordinary course of trade, by manufacturers or producers thereof, as determined by the Commissioner."

The plaintiff takes the position, first, that the price at which it sold its products to Vita-Ray Corporation is the proper basis for the tax since it is the manufacturer's or producer's sales price, upon which the tax was levied; or if incorrect in this, it says that in determining the sales price, advertising and selling costs are to be eliminated, in any event.

The Commissioner originally took the position that the Vita-Ray Corporation was the mere selling agent of the plaintiff and, therefore, that plaintiff's sales price was the price at which it sold its products to the retail trade, to wit, retail price less 40 per cent, and he assessed the tax on this basis. Later, after this suit was filed, the Commissioner reduced this sales price by 7½ per cent thereof, and assessed the tax accordingly, crediting plaintiff's liability for subsequent months with the difference.

It is obvious that the Vita-Ray Corporation was a mere shell. Its activities were carried on by exactly the same people who had carried on these activities for plaintiff before its organization; its officers were the same as plaintiff's officers; its board of directors were the same; it had no operating capital; it had no office space, except that furnished by plaintiff without charge; all of its capital stock of the total sum of $300 was owned by plaintiff. Its existence must be disregarded. Sales made by it must be treated as having been made by the plaintiff. (*Higgins* v. *Smith*, 308 U. S., 473; *Griffiths* v. *Commissioner*, 308 U. S., 355 [Ct. D. 1431, C. B. 1940–1, 136]; *Gregory* v. *Helvering*, 293 U. S., 465 [Ct. D. 911, C. B. XIV–1, 193 (1935)]; *Southern Pacific Co.* v. *Lowe*, 247 U. S., 330; *Gulf Oil Corporation* v. *Lewellyn*, 248 U. S., 71; *E. Albrecht & Son* v. *Landy*, 114 Fed. (2d), 202.)

Treating the sales as having been made by plaintiff, the transaction is governed by section 619(b)1. This provides that if an article is sold at retail, the tax shall be computed on the price for which such articles are sold in the ordinary course of trade by manufacturers or producers thereof. What this price is, is to be determined by the Commissioner.[1]

The Commissioner was wrong in the beginning in fixing the retail price as the price upon which the tax should be computed. The price contemplated was that charged in the ordinary course of trade. In the ordinary course of trade this is the price charged by the manufacturer when he sold to a wholesaler. The defendant seems to admit this now (R., 82). But the Commissioner later reduced the retail price by 7½ per cent thereof, and computed the tax on the remainder. Why he did this is not shown, but it is to be presumed that it was because this was his determination of the price at which manufacturers or producers sold such articles in the ordinary course of trade. This is the price the Commissioner was commanded to determine, and it is to be presumed he acted in accordance with law.

The plaintiff has not shown that this was not the price to wholesalers and, of course, the burden was on it to do so. The price at which plaintiff sold its products to the Vita-Ray Corporation proves nothing; that was nothing more than a sale to itself. Rather, it was no sale at all. The fact that this price was 15 per cent above plaintiff's manufacturing costs proves nothing, in the absence of proof that it was customary for manufacturers of cosmetics to sell to wholesalers on such basis. (We feel sure they did not sell on such basis, because such reckoning eliminates the most valuable element of the product, the consumer's demand for it, built up through advertising). For the same reason, the fact that the Vita-Ray Corporation bought some of its products from other people cheaper than plaintiff charged, proves nothing.

We have carefully studied plaintiff's brief and the record, and conclude that the plaintiff has not borne the burden of showing the price determined by the Commissioner was not that denominated by the statute.

But plaintiff says that if the sales to Vita-Ray Corporation are to be disregarded, nevertheles, advertising costs, at any rate, should be excluded from the sales price. We can not agree that this is so. The price the plaintiff secured for the article was much greater on account of the advertising done.

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[1] Most of the courts have treated such transactions as governed by section 619(b)3, which provides that if the article is sold at less than market price, otherwise than through an arm's length transaction, then the tax shall be computed in the same way as if the article had been sold at retail. By whichever subsection governed, the result is the same.

By advertising, the plaintiff put value in the article no less than when it added the vitamins to the cream; and that value is sold. As was said by the Second Circuit Court of Appeals in *Bourjois, Inc.*, v. *McGowan* (85 Fed. (2d), 510):

"But to take the appellant's products as mere unnamed blends, mixtures, or compositions salable to the trade as such at the time the appellant sold them is to ignore the very thing which gave them their peculiar sales value; that is, the trade names under which they were sold not only eventually to the wholesalers, retailers, and consumers but by the appellant itself to the sales corporations."

The tax is measured by the price for which the manufacturer sold its product. How this price was built up is immaterial.

But, it is argued that section 619(a) requires the elimination of these expenses. This section eliminates from the sales price "transportation, delivery, insurance, installation, or other charge." It is argued that advertising expenses come within the phrase "other charge." We are unable to agree. The items excluded are those expenses which are incurred in addition to the cost of manufacture. Their exclusion indicates no more than that Congress had in mind the sales price f. o. b. factory, and meant to exclude those items of cost which go to make up the delivered or installed sales price.

Certainly advertising expenses are not of the same kind of things which are specifically mentioned—transportation, delivery, installation, and insurance charges.

Furthermore, Congress, in passing the Act of 1939, evidently believed that the Act of 1932 did not provide for the exclusion of advertising costs. Section 3 of the Act of 1939 (53 Stat., 862, 863) reads in part:

"Whether sold at arm's length or not, a transportation, delivery, insurance, or other charge, *and the wholesaler's salesmen's commissions, and costs and expenses of advertising and selling* (not required by the foregoing sentence to be included), shall be excluded from the price only if the amount thereof is established to the satisfaction of the Commissioner, in accordance with the regulations." [Italics ours.]

It will be noted that this sentence is identical with the second sentence of section 619(a) of the Revenue Act of 1932, except that there has been added the portion underlined [in italics], having to do with expenses of advertising and selling. The plaintiff says that this was added to the Act merely for clarification, but we think not, for this reason, among others: Subsection (b) of section 3 of the Revenue Act of 1939 says:

"*The amendments* made by subsection (a) shall be effective only with respect to sales made after the date of the enactment of this Act." [Italics ours.]

It appears, therefore, in passing the Act of 1939, the Congress thought that the exclusion of advertising and selling costs was an amendment of the prior Act, and not merely a clarification thereof.

Note, moreover, that it was not all advertising and selling expenses that were to be excluded under the Revenue Act of 1939; it was only the wholesaler's expenses of advertising and selling. Manufacturer's advertising and selling expenses are not mentioned. By implication they are to be included. This, we think, is a continuation of the policy behind the 1932 Act.

The Circuit Court of Appeals for the Seventh Circuit, in *Campana Corporation* v. *Harrison* (114 Fed. (2d), 400), has reached a contrary conclusion. It was of opinion that selling and advertising costs should be excluded; in fact, that all nonmanufacturing charges were to be excluded. As we have said, advertising has added value to the article, and has enabled the manufacturer to secure therefor a better price, just as have the vitamins and its other tangible component parts. For this reason we see no basis for concluding that Congress meant to exclude these costs.

It results that plaintiff's petition must be dismissed. It is so ordered.

MADDEN, Judge; JONES, Judge; LITTLETON, Judge; and WHALEY, Chief Justice, concur.

INTERNAL REVENUE CODE.

CHAPTER 35.—ASSESSMENT.

1941–12–10654
S. T. 915

Procedure applicable to additional assessments of excise and miscellaneous taxes.

With a view to affording taxpayers every reasonable opportunity, prior to assessment, for hearing and presentation of the facts and law applicable to their cases, the procedure outlined herein will be followed in the administration of the excise and miscellaneous taxes.

1. When an additional assessment, or assesment of delinquent tax, is proposed to be entered on the list (except where delay may jeopardize collection of the tax, or where the amount involved is nominal, or the result of an evident mathematical error), a preliminary letter will be directed to the taxpayer advising him briefly of the basis and amount of the proposed assesment and concluding with the following paragraph:

> Assessment of the tax, with statutory interest thereon, will be withheld for a period of 15 days from the date of this letter in order to afford you an opportunity to submit to this office a protest with supporting facts, or to request a conference with this office.

2. In cases of the character described, care should be taken to see that no assessment is made until after the expiration of the notice period. If the taxpayer submits a protest or requests a conference, assessment will be deferred until careful consideration has been given to the facts and arguments submitted in the brief or at the conference, unless it appears that the taxpayer is merely endeavoring to delay assessment without good cause, or further delay may jeopardize collection of the tax.

3. The 15-day notice period prescribed in paragraph 1 is subject to some flexibility and may be extended in appropriate cases where collection will not be jeopardized by such extension.

4. In cases where the taxpayer has actual notice, as a result of conferences in or correspondence from this office, of the proposed assessment, its basis, and approximate amount, the foregoing procedure need not be followed.

5. Internal revenue agents and general deputy collectors will furnish the taxpayer with a copy of the report in cases where additional or delinquent tax is recommended, except where the report contains information of a confidential nature, such as a case involving fraud. At the conclusion of the investigation the taxpayer should be advised that he is privileged to submit a protest or request a conference in regard to the proposed assessment. Each investigating officer shall state in his report whether he has furnished the taxpayer with a copy thereof and has advised him of his privilege of protest and hearing.

6. The procedure outlined above is effective as of March 1, 1941.

ADMISSIONS TAX.

INTERNAL REVENUE CODE.

SECTION 1702.—PRINTING OF PRICE ON TICKET.

REGULATIONS 43 (1940), SECTION 101.32: Requirements applicable to tickets. 1941–5–10583 Mim. 5145

Requirements regarding the printing of tickets of admission.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C., January 10, 1941.

Collectors of Internal Revenue and Others Concerned:

It appears that there has been considerable confusion, especially among the ticket printers, concerning the requirements of the law and regulations regarding the printing of admission tickets. For this reason, especial attention is called to the following:

(1) In accordance with section 1702 of the Internal Revenue Code, the price at which every admission ticket or card is sold must be conspicuously and indelibly printed, stamped, or written on that part of the ticket which is to be taken up by the management. This requirement is applicable to tickets which are to be sold for less than 21 cents as well as those selling for 21 cents or more.

Despite this requirement of the law, ticket printers are sometimes requested to print tickets which do not show the price, but which have a space in which the price is to be later stamped or written by the theater or other place before the tickets are sold. Ticket printers, as such, do not incur liability to any penalty by printing such tickets. However, in view of the fact that the theater or other place will incur liability to the penalties provided by section 1703 of the Internal Revenue Code if the price is not printed, stamped, or written on the tickets at the time they are sold, the practice of printing tickets without the price is regarded by the Bureau as likely to result in violations of the law by proprietors of places of admission and wherever possible orders for such tickets should be discouraged by the printer.

(2) So-called "stock tickets," which do not show the price, may not be used by any theater or other place (except by overstamping or writing the admission price thereon) without incurring liability to the penalties provided by section 1703 of the Internal Revenue Code.

All taxable admission tickets must show (in addition to the price, the tax, and the total) the name of the place to which they are valid for admission and must either be dated or serially numbered.

(3) Tickets sold at reduced rates must show the regular established price of admission and also the reduced price, the tax due, and the total.

NOTE.—The tax on the reduced price is based on the regular established price of admission (except in the case of bona fide employees, municipal officers on official business, and children under 12 years of age). For example, tickets sold to students, 12 years of age or over, to ladies, to members of Civilian Conservation Corps, or other groups or classes of individuals at a price less than the established price of admission to others must show the full

tax at the rate of 1 cent for each 10 cents or fraction thereof of the regular established price to others for the same or similar accommodations.

No tax attaches to free admissions to a spoken play (not a mechanical reproduction) whether or not set to music or with musical parts or accompaniments, which is a consecutive narrative interpreted by a single set of characters, all necessary to the development of the plot, in two or more acts, the performance consuming more than 1 hour and 45 minutes of time and the tax on tickets to such a spoken play when sold at the ticket office of theaters at reduced rates is on the price for which sold.

(4) Tickets selling for $1, including tax, should show established price 91 cents, Federal tax 10 cents, total $1.01, reduced price $1. The total tax of 10 cents must be paid over to the Government.

(5) Season tickets must show the established price of the season ticket, the tax, and the total.

(6) In accordance with the provisions of section 101.32 of Regulations 43 (1940 edition), if the ticket covering taxable admissions shows the seat or box for which it is valid, the location and seat or box number must appear on that part of the ticket which is taken up by the management as well as on the stub which is given to the patron.

(7) Any circuit owning and operating a number of theaters and desiring to use tickets showing the name of the circuit owning the theaters rather than the name of each individual theater must secure written permission from the Bureau, after furnishing to the Bureau information showing the number of theaters operated by it, whether tickets are sold at all of the theaters through ticket vending machines which record the number of tickets sold, and the nature of the records kept at the home office and at each theater.

(8) All ticket printers should furnish to the collectors the information required by section 101.33, Regulations 43 (1940 edition), that is, the name of the customer ordering admission tickets the number of the tickets ordered, the opening and closing serial numbers, and proofs or sample copies of the tickets themselves. The collector's office should, upon receipt of such proofs or sample copies of the tickets, examine them to verify whether they are in all instances printed in accordance with the law and regulations and with respect to any improperly printed tickets (including those marked "tax free" but as to which there is no record of an exemption having been granted), an immediate investigation should be made to ascertain whether admissions tax is due and, if so, whether adequate steps have been taken to insure its collection.

A printer may make application to the collector of internal revenue for the district in which he is located for franked envelopes in which to furnish to collectors the information required by section 101.33, Regulations 43 (1940 edition).

(9) Any organization ordering tickets printed with the words "tax free" on the grounds that the proceeds will inure to the benefit of an organization or person coming within the provisions of section 1701 of the Internal Revenue Code should exhibit to the printer an exemption certificate on Form 755A secured from the collector of internal revenue.

All inquiries in regard to this mimeograph should be addressed to the Commissioner and marked for the attention of MT:ST.

TIMOTHY C. MOONEY,
Acting Commissioner.

TELEGRAPH, TELEPHONE, RADIO, AND CABLE FACILITIES.

INTERNAL REVENUE CODE.

SECTION 3465, AS AMENDED BY SECTION 1 OF THE REVENUE ACT OF 1939 AND SECTION 209 OF THE REVENUE ACT OF 1940.—IMPOSITION AND RATE OF TAX.

REGULATIONS 42 (1932), Article 19: Services rendered to the United States, etc. (Also Section 3466.) 1941–12–10653 S. T. 914

Payments made directly by the Federal Government for telegraph, telephone, cable, or radio dispatches or messages in connection with construction work being performed by contractors for the War Department and/or Navy Department under a cost-plus-a-fixed-fee contract are exempt from the tax imposed by section 3465 of the Internal Revenue Code, as amended.

Advice is requested whether payments made by the Federal Government for telegraph, telephone, cable, or radio dispatches or messages in connection with construction work being performed for the War Department and/or Navy Department under a cost-plus-a-fixed-fee contract, as distinguished from a lump-sum contract, are exempt from the tax imposed by section 3465 of the Internal Revenue Code, as amended by section 1 of the Revenue Act of 1939 and section 209 of the Revenue Act of 1940.

Section 3465 of the Internal Revenue Code, as amended, imposes a tax upon payments for telegraph, telephone, cable, or radio dispatches, messages, and conversations originating within the United States and upon payments for leased wire or talking circuit special service. Section 3466 provides in part that no tax shall be imposed under section 3465 upon any payment received for services or facilities furnished to the United States.

Under the cost-plus-a-fixed-fee contracts in question, all telegraph, cable, and radio dispatches or messages are prepared on standard Government forms and are certified by the Government contracting officer or his representative as being for an exclusive governmental purpose. All charges for such dispatches and messages and for telephone messages are billed at regular Government rates, and are paid directly by the Government. Whenever possible, such charges are billed directly to the Government.

It is held that payments made directly by the Federal Government for telegraph, telephone, cable, and radio dispatches or messages in connection with construction work being performed by contractors for the War Department and/or Navy Department under a cost-plus-a-fixed-fee contract are exempt from the tax imposed by section 3465 of the Internal Revenue Code, as amended.

TRANSPORTATION OF OIL BY PIPE LINE.

INTERNAL REVENUE CODE.

SECTION 3460, AS AMENDED BY SECTION 1 OF THE REVENUE ACT OF 1939 AND SECTIONS 209 AND 210 OF THE REVENUE ACT OF 1940.—TAX.

REGULATIONS 42 (1932), ARTICLE 26: Basis of tax. 1941-11-10644
G. C. M. 22580

The M Company, a producer of gasoline and crude petroleum, sold for export crude petroleum with a specified gasoline content of 20 per cent. Gasoline and crude petroleum were moved separately through pipe lines from inland points to shore tanks of the M Company, where the required amount of gasoline was blended with the crude petroleum in order to meet the 20 per cent specification contained in the contract of sale. The blended product was later delivered on the buyer's vessels.

Held, that the blending of the crude petroleum and gasoline constituted a break in the continuity of the movement thereof, and that all movements of the crude petroleum and gasoline by pipe line prior to the blending were domestic in character and subject to tax under section 3460 of the Internal Revenue Code, as amended.

An opinion is requested whether under the circumstances hereinafter stated the separate movements by the M Company of crude petroleum and gasoline by pipe lines from inland points to the shore tanks of the M Company, where such products were blended and were thereafter delivered on buyer's vessel for exportation, are subject to the tax imposed by section 3460 of the Internal Revenue Code, as amended by section 1 of the Revenue Act of 1939 and sections 209 and 210 of the Revenue Act of 1940.

Section 3460 of the Internal Revenue Code, as amended, imposes a tax upon the transportation of crude petroleum and liquid products thereof by pipe line originating before July 1, 1945.

The M Company, a producer of crude petroleum and gasoline, entered into a contract with a foreign corporation for the sale and exportation of crude petroleum with a gasoline content of not less than 20 per cent at a certain price per barrel delivered on the buyer's vessels at designated wharves owned by the M Company. Inasmuch as the gasoline content of the crude petroleum produced by the M Company was less than 20 per cent, it was necessary to blend the required amount of natural or casinghead gasoline with the crude petroleum in order to meet the 20 per cent specified in the contract of sale. The crude petroleum and gasoline were moved separately through pipe lines from inland points into the shore tanks of the M Company where the blending occurred. The blended product remained in the shore tanks until delivered on the buyer's vessels.

In view of the constitutional prohibition against levying a tax on articles exported from any State (Article I, section 9, clause 5, of the Constitution of the United States), it becomes necessary to determine the point at which exportation of the petroleum products in question

began. The general rules relating to such determination are stated in S. T. 679 (C. B. XII–1, 442 (1933)) as follows:

> The test of tax exemption on transportation by pipe line of oil intended for exportation is the continuity of the movement from the point of origin in the United States to its foreign destination. The mere fact that oil transported by pipe line is finally exported does not necessarily mean that it was continuously in course of exportation after it was started on its movement from its point of origin.
>
> In order for a tender of oil to be considered as being in the course of exportation and exempt from tax, it must be shown (1) that prior to commencement of the movement the shipper had in his possession a contract or order calling for delivery of the oil beyond the boundaries of the United States, and (2) that subsequently there was delivered at a point of origin in the United States the amount and quality of oil covered by the contract or order, to be transported by a continuous movement to the destination beyond the boundaries of the United States.
>
> In order to be exempt as an export shipment, there must be no break in the movement, the oil must not come to rest en route. In case there is a break in continuity, the first movement is domestic in its character and amounts paid for the transportation are taxable.
>
> * * * * * * *
>
> A break occurs or the oil comes to rest when, as it moves from its point of origin to a foreign destination, it reaches a place where, at the instance of the shipper or consignee, or their agent, it is stopped for a business purpose, such as a sale, storage, refining or other manufacture, reconsignment, or reshipment, and not in accommodation to the means of transportation instituted by the carriers themselves. Instances of a break in the continuity of an export movement are (1) oil sent to a consignee at a certain place within the United States en route to a foreign destination where the consignee, upon receipt of the oil, refines, *mixes*, or accumulates it for the purpose of selling it, or (2) oil consigned to a definite foreign destination and, prior to its reaching such destination, it is reconsigned at a point in the United States to another destination. * * * After each break a new movement begins. Accordingly, the export movement free from tax is the one from the last point in the United States where the shipment is broken or the oil comes to rest. [Italics supplied.]

What constitutes a break in continuity of the movement is a question which must, in the last analysis, depend upon all the particular facts of each case. Storage, for example, may or may not constitute a break in continuity of the movement, depending largely upon the length of time of the storage and the purpose for which the product was stored. If the storage is for a business purpose, some purpose other than a mere facility for normal transportation, a break in the continuity of the movement occurs. (*Susquehanna Coal Co.* v. *South Amboy*, 288 U. S., 665; *Diamond Match Co.* v. *Ontonagon*, 188 U. S., 82; and *Prairie Oil & Gas Co.* v. *Jefferson County, Tex.*, 76 Fed. (2d), 545.)

It is the opinion of this office that a break in the continuity of the movement occurred in the instant case when the crude petroleum and the natural or casinghead gasoline were blended in the shore tanks, since the act of mixing (blending) the products constituted a break in the transportation. (S. T. 679, supra.) This conclusion is supported by the fact that the export product specified in the contract, that is, crude petroleum with a gasoline content of not less than 20 per cent, did not exist until the crude petroleum was mixed in the shore tanks with natural or casinghead gasoline to bring it up to the contract specification. The export movement began when the blended product (crude petroleum with a gasoline content of 20 per cent) left the

shore tanks in pipe lines which carried such product directly to the tanks aboard the buyer's vessels. All movements of the crude petroleum and gasoline by pipe line prior to the time of blending in the shore tanks were domestic in character. It follows that the transportation of the crude petroleum and natural or casinghead gasoline by pipe line which occurred prior to the blending in the shore tanks is subject to tax under section 3460 of the Internal Revenue Code, as amended.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

STAMP TAXES.

INTERNAL REVENUE CODE.

SECTION 1802(b), AS AMENDED BY SECTIONS 1 AND 402 OF THE REVENUE ACT OF 1939, AND SECTIONS 209 AND 210 OF THE REVENUE ACT OF 1940.—CAPITAL STOCK (AND SIMILAR INTERESTS)—SALES AND TRANSFERS.

REGULATIONS 71 (1932), ARTICLE 34: Sales or transfers subject to tax. 1941–8–10614 S. T. 913

The transfer of stock of the M Corporation, a Delaware corporation whose charter was repealed due to failure to pay the Delaware franchise tax, is subject to stamp tax under section 1802(b) of the Internal Revenue Code, as amended.

S. T. 671 (C. B. XII–1, 437 (1933)) modified.

Advice is requested whether the transfer of stock of the M Corporation, a Delaware corporation whose charter was repealed due to failure to pay the required franchise tax to the State of its incorporation, is subject to stamp tax under section 1802(b) of the Internal Revenue Code, as amended by sections 1 and 402 of the Revenue Act of 1939 and sections 209 and 210 of the Revenue Act of 1940.

Section 1802(b), as amended, imposes a stamp tax on all sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to any shares or certificates of stock, or of profits, or of interest in property or accumulations, of any corporation, or of any investment trust or similar organization, with certain exceptions not here material.

The M Corporation, a Delaware corporation, defaulted in the payment of its franchise tax to the State of Delaware. Pursuant to the provisions of section 72 of chapter 6 of the Revised Code of Delaware (1935), the corporation's charter was repealed as of April 1, 1934. In December, 1935, a creditor's petition for the reorganization of the corporation was filed in the United States District Court for the District of Delaware. In March, 1940, the proceedings were transferred to the United States District Court for the Eastern District of Kentucky and are now pending in that court. The question presented is whether a transfer of stock of the M Corporation by the owner of such stock is subject to stamp tax.

Section 71 of chapter 6 of the Revised Code of Delaware (1935) provides that if a corporation for two consecutive years fails to pay its franchise tax its charter shall be void. In section 74 of chapter 65 of the Revised Code of Delaware it is provided in part as follows:

* * * any corporation existing under the laws of this State whose charter has become inoperative by law for nonpayment of taxes * * * may at any time procure an extension, restoration, renewal or revival of its charter * * *. * * * and thereupon the said corporation shall be renewed and revived with the same force and effect as if its charter had not become inoperative and void * * *. Such reinstatement shall validate all contracts, acts, matters and things made, done and performed within the scope of its charter by such corporation * * * during the time when such charter was inoperative or void * * * with the same force and effect and to all intents and purposes as if said charter had at all times remained in full force and effect * * *.

In S. T. 671 (C. B. XII-1, 437 (1933)) it is stated:

If the issuing corporation has actually gone out of business, either through surrendering its charter or having its charter revoked by the State of its incorporation for nonpayment of taxes, etc., it is held that no stock exists. The corporation having been dissolved, the certificates are really not certificates of corporate stock because the corporation is no longer in existence.

On the transfer of certificates formerly issued by such dissolved corporation, no transfer stamp tax liability will be incurred. However, if the corporation is still in existence the transfer of the certificates is taxable under the law even though the certificates are otherwise worthless.

It is impossible to lay down a broad general rule to cover the type of case here involved. In other words, each case must be considered upon its own facts. It may be said, however, that the existence or nonexistence of a corporate charter is not necessarily a controlling factor. Even though a corporation's charter has been forfeited and the corporation has been dissolved, the dissolution merely has the effect of terminating those rights of the stockholders which are personal in character, but does not terminate the stockholder's property rights in the assets of the corporation. Such property rights are not terminated prior to the distribution of the corporation's assets. (*Bijur* v. *Standard Distilling & Distributing Co.*, 74 N. J. E., 546, 70 Atl., 934.)

The repeal of the charter of the M Corporation did not render the charter completely null and void, but merely suspended and made it inoperative subject to being renewed or revived as provided in section 71 of chapter 6 of the Revised Code of Delaware (1935). There has been no distribution of the corporate assets. The stock in question, therefore, represents an interest in the property of the M Corporation.

In view of the foregoing, it is held that the transfer of stock of the M Corporation is subject to the stamp tax imposed by section 1802(b) of the Internal Revenue Code, as amended.

S. T. 671 (C. B. XII-1, 437 (1933)) is modified to the extent that it is inconsistent with this ruling.

SECTIONS 1800, 1802(b), 3480, AND 3481(a), AS AMENDED.

REGULATIONS 71 (1932), ARTICLE 35: Sales or transfers not subject to tax. (Also Article 120.) — 1941-2-10562 S. T. 912

Sales or transfers of securities by a foreign government, stamp tax having been paid upon the transfers of such securities to the foreign government, are not subject to the stamp taxes imposed by sections 1800, 1802(b), 3480, and 3481(a) of the Internal Revenue Code, as amended.

Advice has been requested whether certain sales or transfers of shares or certificates of stock or bonds by the British Government are subject to the stamp taxes imposed by sections 1800, 1802(b), 3480, and 3481(a) of the Internal Revenue Code, as amended.

In order to be able better to prosecute the present war in Europe, the British Government, acting pursuant to its "Defence (Finance) Regulations," has transferred to the British Treasury certain shares or certificates of stock or bonds at a specified price for each security.

The shares or certificates of stock or bonds thus transferred to the British Treasury will be sold or transferred in the United States by the British Government, stamp taxes having been paid upon the transfers to such Government.

Based upon the foregoing facts, it is held that the sales or transfers by the British Government of such shares or certificates of stock or of such bonds are not subject to stamp taxes.

SECTION 1802(b), AS AMENDED BY SECTIONS 1 AND 402 OF THE REVENUE ACT OF 1939, AND SECTIONS 209 AND 210 OF THE REVENUE ACT OF 1940.—CAPITAL STOCK (AND SIMILAR INTERESTS)—SALES AND TRANSFERS.

REGULATIONS 71 (1932), ARTICLE 35: Sales or transfers not subject to tax. 1941–19–10711 S. T. 918

(Also Section 3481(a), as amended, and Article 120.)

The transfer of corporate stock and bonds from the name of a guardian to the name of his ward in the State of Arkansas is not subject to stamp tax.

Advice is requested whether the transfer of corporate stock and bonds from the name of a guardian to the name of his ward in the State of Arkansas is subject to stamp tax under section 1802(b) of the Internal Revenue Code, as amended by sections 1 and 402 of the Revenue Act of 1939, and sections 209 and 210 of the Revenue Act of 1940, and under section 3481(a) of the Internal Revenue Code, as amended by section 210 of the Revenue Act of 1940, respectively.

The law imposes a stamp tax on all sales and transfers of legal title to any shares or certificates of corporate stock or corporate bonds, with certain exceptions not here applicable. Where corporate stock or bonds are transferred from a guardian to a ward, the transfer is subject to stamp tax if under the local law the guardian, and not the ward, held the legal title to the stock or bonds. (S. T. 832, C. B. XV–1, 418; S. T. 855, C. B. 1937–1, 336; S. T. 873, C. B. 1938–2, 410; S. T. 911, C. B. 1940–2, 331.)

There is no provision of the Arkansas statutes dealing specifically with the question whether a guardian in that State acquires legal title to the personal property of his ward. However, such statutes clearly indicate that the ward has legal title to such property, the guardian having merely the care and management thereof. (Pope's Digest of the Statutes of Arkansas, 1937, chapter 78, "Guardian and Ward.")

In *Gentry* v. *Owen* (14 Ark., 396, 60 American Decisions, 549), holding that in Arkansas a guardian never succeeds to the legal rights of his ward and that a change of guardians leaves a ward's legal title undisturbed, the court stated in part as follows:

* * * But the guardian does not succeed to the legal rights of the ward; by virtue of his guardianship he becomes the authorized agent of the minor to protect his person, and to take care of and manage his property, the legal title to which is not in him but in his ward, and in whose name contracts are made and suits touching his rights are prosecuted. Upon a change of guardians, the property, the legal title in which still remains in the ward, passes to the new guardian, whose rights and duties are coextensive with his predecessors.

In *Norvell* v. *McFadden* (173 Ark., 588, 292 S. W., 1001) it was held that a ward, upon coming of age, could maintain an action at law for

conversion against a third person who had improperly received assets of the ward's estate from the guardian. The decision in that case was predicated on the theory that legal title to the property was in the ward. In *Russell* v. *Johnson* (193 Ark., 541, 101 S. W. (2d), 172), the Supreme Court of Arkansas stated in part as follows:

> Without an order of the probate court, a guardian can not invade the principal of his ward's estate for any purpose, and the order must be in advance of the expenditure.

Since in Arkansas legal title to the personal property of a ward remains in the ward, it is held that the transfer of stocks and bonds from the name of a guardian to the name of his ward in the State of Arkansas is not subject to stamp tax under sections 1802(b) and 3481(a) of the Internal Revenue Code, as amended.

SECTION 3481, AS AMENDED BY SECTION 210 OF THE REVENUE ACT OF 1940.—TRANSFER OF BONDS.

REGULATIONS 71 (1932), ARTICLE 120: Basis of tax. (Also Section 1808(a).) 1941–16–10690 S. T. 916

> The exemption from documentary stamp tax provided in section 1808(a) of the Internal Revenue Code, relating to "Government and State obligations," is not affected by section 4(a) of the Public Debt Act of 1941.

Advice is requested whether the exemption from documentary stamp tax provided in section 1808(a) of the Internal Revenue Code is affected by section 4(a) of the Public Debt Act of 1941, approved February 19, 1941 (Public, No. 7, Seventy-seventh Congress, first session).

Section 3481 of the Internal Revenue Code, as amended by section 210 of the Revenue Act of 1940, provides in part as follows:

> (a) IMPOSITION OF TAX.—On all sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to any of the instruments mentioned or described in section 1801 and of a kind the issue of which is taxable thereunder * * *.

Section 1808 of the Internal Revenue Code, made applicable to section 3481(a) by section 3483, provides in part:

> There shall not be taxed under this chapter—
> (a) GOVERNMENT AND STATE OBLIGATIONS.—Any bond, note, or other instrument, issued by the United States, or by any foreign Government, or by any State, Territory, or the District of Columbia, or local subdivision thereof, or municipal or other corporation exercising the taxing power * * *.

Section 4(a) of the Public Debt Act of 1941, supra, provides as follows:

> Interest upon, and gain from the sale or other disposition of, obligations issued on or after the effective date of this Act by the United States or any agency or instrumentality thereof shall not have any exemption, as such, and loss from the sale or other disposition of such obligations shall not have any special treatment, as such, under Federal tax Acts now or hereafter enacted; except that any such obligations which the United States Maritime Commission or the Federal Housing Administration has, prior to the effective date of this Act, contracted to issue at a future date, shall when issued bear such tax-exemption privileges as were, at the time of such contract, provided in the law authorizing their issuance. For the purposes of this subsection a Territory, a possession of the United States, and the District of Columbia, and any political subdivision thereof, and any agency or instrumentality of any one or more of the foregoing, shall not be considered as an agency or instrumentality of the United States.

It is clear from the specific language used in section 4(a) of the Public Debt Act of 1941, supra, that Congress had in mind income and other similar taxes and not documentary stamp taxes. It is accordingly held that the exemption provided in section 1808(a) of the Internal Revenue Code, supra, relating to "Government and State obligations," is not affected by section 4(a) of the Public Debt Act of 1941, supra.

SECTION 3482, AS AMENDED BY SECTION 1 OF THE REVENUE ACT OF 1939, AND SECTIONS 209 AND 210 OF THE REVENUE ACT OF 1940.—CONVEYANCES.

REGULATIONS 71 (1932), ARTICLE 84: What constitutes real property determinable by law of State where located. 1941–16–10691 S. T. 917

Oil and gas leases of indefinite duration covering lands in Michigan, or assignments thereof, constitute conveyances of realty subject to stamp tax.

Advice is requested whether oil and gas leases of indefinite duration covering lands in Michigan, or assignments of such instruments, constitute conveyances of realty subject to stamp tax under section 3482 of the Internal Revenue Code, as amended by section 1 of the Revenue Act of 1939 and sections 209 and 210 of the Revenue Act of 1940.

The law imposes a stamp tax on any "Deed, instrument, or writing * * * whereby any lands, tenements, or other realty sold shall be granted, assigned, transferred, or otherwise conveyed to, or vested in, the purchaser or purchasers, * * * when the consideration or value of the interest or property conveyed, exclusive of the value of any lien or encumbrance remaining thereon at the time of sale, exceeds $100 * * *." What constitutes "lands, tenements, or other realty" is determinable by the law of the State in which the property is situated. (Article 84, Regulations 71.)

The Supreme Court of Michigan, in *Jaenicke* v. *Davidson et al.* (290 Mich., 298, 287 N. W., 472), held (syllabus):

A lease of oil and gas rights in tract of land constitutes an "interest in real property" and not a mere "option."

In the body of its opinion the court stated:

"It goes without saying that the assignment of such rights from one holder to another (as in the instant case) is in effect a releasing or at least a transferring of the rights of a lessee to his assignee. Therefore such assignments are as much dealings in interests in real estate as are original leasehold transactions.

"In this connection it is interesting to note that at least by clear inference the legislature of this State has considered oil and gas leases as conveyances of real estate.

"'No covenant shall be implied in any conveyance of real estate, except oil and gas leases, whether such conveyance contain special covenants or not.' (C. L. 1929, section 13281; Stat. Ann., 26.524.)"

In view of the foregoing, it is held that oil and gas leases of indefinite duration covering lands in Michigan, or assignments of such instruments, constitute conveyances of realty subject to stamp tax under section 3482 of the Internal Revenue Code, as amended.

PROCESSING TAXES.

TITLE VII.—REFUNDS OF AMOUNTS COLLECTED UNDER THE AGRICULTURAL ADJUSTMENT ACT. (1936)

REGULATIONS 96, ARTICLE 202: Facts and evidence in support of claim. 1941–17–10696 Ct. D. 1507

PROCESSING TAX—AGRICULTURAL ADJUSTMENT ACT—REVENUE ACT OF 1936—DECISION OF COURT.

1. CLAIM FOR REFUND—PORK PACKER—CUSTOMS SLAUGHTERER—FIRST DOMESTIC PROCESSOR.

A pork-packing company which purchased hogs in the open market and engaged a customs slaughterer to kill them at an agreed price per head was not entitled to the refund of processing taxes paid. Title VII of the Revenue Act of 1936 restricts the refund of processing taxes to those persons who were the first domestic processors and who alone were obligated to pay the tax. In the case of hogs the slaughterer is the first domestic processor and the taxpayer under the Agricultural Adjustment Act.

2. UNITED STATES PROCESSING TAX BOARD OF REVIEW—JURISDICTION.

The United States Processing Tax Board of Review has no jurisdiction to review the Commissioner's disallowance of refund claims of taxpayers who paid taxes with respect to the processing of agricultural commodities for customers for a charge or fee.

3. CONSTITUTIONALITY OF REFUND STATUTE.

Title VII of the Revenue Act of 1936 does not violate due process in failing to provide a refund to a petitioner who was not the first domestic processor and taxpayer under the Agricultural Adjustment Act.

4. REHEARING DENIED.

Petition for rehearing denied October 1, 1940.

5. CERTIORARI DENIED.

Petition for writ of certiorari denied February 3, 1941.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

Fuhrman & Forster Co., petitioner, v. *Commissioner of Internal Revenue, respondent.*

[114 Fed. (2d), 863.]

Petition for review of decision of the United States Processing Tax Board of Review.

Before SPARKS, TREANOR, and KERNER, Circuit Judges.

[July 22, 1940.]

OPINION.

KERNER, Circuit Judge: Fuhrman & Forster Co. (petitioner) filed a refund claim for sums alleged to have been paid as processing taxes under the Agricultural Adjustment Act. (48 Stat., 31, 7 U. S. C. A., section 601 *et seq.*) The Commissioner of Internal Revenue rejected the claim on the ground that the amount sought to be recovered had not been paid by or collected from the petitioner under the Agricultural Adjustment Act. Petitioner then sought review of the disallowance in the United States Processing Tax Board of Review. There, upon motion of the Commissioner, the Board dismissed the petition for lack of jurisdiction. The case is now before us on petition to review pursuant to section 906(g) of the Revenue Act of 1936. (49 Stat., 1750, 7 U. S. C. A., section 648.)

There are also three companion petitions—Nos. 7173, 7174, and 7175—filed with this court, which present the identical problem before us in the instant case. Upon motion made and order duly entered, the decision in this case shall apply to and be held as controlling in the other three cases.

The petitioner is engaged in the meat packing business and to the trade it is known as a "pork packer." Except for killing floor facilities, its business with respect to cutting, curing, smoking, cooking, manufacturing sausage and other processing is virtually the same as other packers who operate their own abattoir. The petitioner purchased the hogs in the open market (from the producer or commission houses) and engaged the C. A. Burnette Co. (a customs slaughterer) to kill the hogs at an agreed price per head. After the killing and chilling operations which are conducted under the supervision of the petitioner, the carcasses and viscera are transported to petitioner's plant for the treatment above described. Counsel for petitioner states that the customs slaughterer is a "bailee for hire to do a specific job under a contract" and that "with respect to the larger meat packing companies who own and operate their own abattoir, the slaughter of hogs is the first of a series of processes in preparing the hogs for market."

Petitioner paid the processing taxes for November and December of 1933, amounting to $13,711.23, directly to the collector of internal revenue. Later the collector returned the payments with instructions to pay the C. A. Burnette Co. Thereafter the collector demanded payment of and received the tax from C. A. Burnette Co. From that time on C. A. Burnette Co. sent the petitioner invoices for the killing charge and separate notices of the processing taxes on hogs slaughtered. In turn the petitioner paid C. A. Burnette Co. the killing fee and processing tax by separate checks, and recorded the disbursements on its records as processing taxes paid. The money collected from the petitioner was actually used by C. A. Burnette Co. for the payment of the processing taxes. The only exception to this method of payment appears to be the payment by the petitioner of $2,589.13 directly to the collector on July 1, 1935. Although the petitioner has filed a refund claim for $260,075.15 (the amount of processing taxes paid as above described), the petitioner indicates that it bore the burden only to the extent of $18,126.43.

In the instant case counsel contends that petitioner was the processor within the intendment of the Agricultural Adjustment Act (48 Stat., 31), and that it ought not to be denied the right to a refund because it was compelled to pay the tax to the slaughterer. On the other hand counsel for the Commissioner contends that the slaughterer was the taxpayer under Title VII of the Revenue Act of 1936 (49 Stat., 1747). The main question here involved, is whether the petitioner was the processor who was obligated to pay the processing tax under the statute.

The taxing statute.—The Agricultural Adjustment Act was enacted in 1933 and the pertinent provisions for purpose of discussion herein are: (1) The Act imposed the processing tax upon the "first domestic processing" of the commodity and provided that the tax "shall be paid by the processor." (48 Stat., 35.) (2) It also provided that the term "processing" means "In case of hogs, * * * the slaughter of hogs for market." (48 Stat., 36.) It further provided (3) that no tax shall be required to be paid on processing by or for producers for home consumption, and (4) that "The Secretary of Agriculture is authorized, by regulations, to exempt from the payment of the processing tax the processing of commodities. by or for the producer thereof for sale by him * * *." (48 Stat., 39.)

As the bill passed the House of Representatives it contained (1) and (3) above, a provision empowering the Secretary of Treasury to define "processing with respect to any commodity," and a provision stating that the Secretary of Agriculture is authorized "to exempt producers from the payment of the processing tax with respect to hogs * * * in cases where the producer's sales of the products resulting from the processing * * * do not exceed $100 per annum." (Congressional Record, volume 77, pages 671–766.) In the Senate amendments were introduced to the House bill and these were referred to the Committee on Agriculture and Forestry for consideration. (Congressional Record, volume 77, pages 786 *et seq.*) Later this committee reported the bill as amended to the Senate for general discussion thereon. (Congressional Record, volume 77, pages 1350 *et seq.*) For our particular purpose, the committee deleted the definition and exemption provisions described above and added (2). Thus the bill as amended contained (1), (2), and (3) already described.

The pertinent discussion indulged in by the Senate Members centered around a hypothetical set of facts which may be stated briefly as follows: a producer kills his own hog, grinds it up, packs it into sausage; he uses part of it for home consumption and sells part of it to the local grocer; what are the consequences of these actions under the bill as amended? (See Congressional Record, volume 77, pages 1562-1565, 1629.) In the discussion that followed, the Members of the Senate expressed what they thought would be the consequences under the facts of the hypothetical problem. It was concluded that there were at least three processing operations in the problem but that provision (1) of the bill as amended indicated clearly that the tax is imposed on the initial processing operation, the actual killing; that killing the hog for home consumption was exempted under provision (3) of the bill as it passed the House or as amended by the Senate and that the killing of the hog for sale to the grocer was taxable under provision (2) of the bill as amended by the Senate. Therefore, an amendment was introduced immediately, in the form of provision (4) already described, to provide for occasional sales by the producer of his processed hog.

The provisions of the House bill as amended by the Senate—namely, parts (1), (2), (3), and (4)—became part of the Agricultural Adjustment Act. Part (2) was discussed in the Senate, the body that added it to the bill, and in that discussion its relation to (1), (3), and (4) was emphasized. If pages 1562 to 1565 of the Congressional Record (devoted to the Senate discussion summarized above) mean anything at all, they mean that the legislators who were responsible for part (2) thought the following: that were the exemption provisions of the bill deleted, not even a farmer who killed his own hog and sold part of the carcass to the local grocer was immune from taxation; that even he would be a slaughterer of hogs "for market" and therefore liable for the processing tax. We are convinced that the words "for market" in the statute are used to distinguish between the slaughtering of hogs by or for an owner for home consumption and the slaughtering of hogs where the resultant product is sold.

Agricultural commodities on their way to general consumption as food or for industrial purposes usually undergo a series of one or more processing operations to prepare them for use and distribution. Thus hogs are not consumed as raw materials but in the form of pork products derived from certain processing operations. And inasmuch as the tax is levied on the processing of the commodity, it is necessary to take the commodity either as it enters the processing operations or after it emerges therefrom. The statute recognized these facts when it imposed the tax on the *first processing* of the hogs and provided that in the case of hogs the term *processing* meant the *slaughter of hogs* for market. The tax attached at the slaughtering operations, the initial operation in the series of operations necessary to prepare the hogs for market. It follows too that a tax attaching to the product as it emerges from the subsequent processing operations, would fail to reach part of the commodity on account of the loss of weight during the operations.

As soon as the Agricultural Adjustment Act was passed, the Department of Agriculture prepared regulations interpreting the term "processing" with respect to certain agricultural commodities. (Section 9(d), 48 Stat., 36.) In the case of hogs the first regulations defined the term in the words of the statute itself—"The first domestic processing is the slaughtering of hogs for market." (Hog Regulations, Series 1, effective November 5, 1933.) Later the Department of Agriculture availed itself of section 15(b) of the Act (48 Stat., 39) and made two exceptions to the standard that the first domestic processing is the slaughtering of hogs. (Hog Regulations, Series 1, No. 1, issued October 29, 1934.) These exceptions exempted the "producer" or "feeder" who slaughtered his own hogs[1] and sold the carcass to such transferees as butchers, packers, retailers, hotels and restaurants. In these instances the initial act of the transferee in preparing the carcass for use was held to constitute the "first domestic processing." No other hog regulations were issued after October 29, 1934.

These departmental regulations were further refined by Treasury decisions and rulings issued by the Bureau of Internal Revenue. (See section 10(d), 48 Stat., 37.) Regulations are general rules only and often special problems have to be met. The effect of the regulations, Treasury decisions and Bureau rulings is to

[1] A *feeder* was defined as a person engaged in the fattening of hogs for market or in farming operations, except "retailers, wholesalers or distributors of meat, butchers, abattoirs, slaughterhouses, packers, factors or commission merchants." A *producer* was a person who owned "the hog at the time of farrowing."

give an exact statement of what is to be taxed, who is to be taxed and at what point in the processing operation the tax is to be imposed. Our exact factual situation, the case of the customs processor, soon came to the attention of the tax collectors. Who was liable for the tax—the customs slaughterer or his customer (pork packer)? On May 14, 1934, the ruling was made that the customs slaughterer was the first domestic processor of the hogs in such a case and that he was liable for the processing tax. (See Internal Revenue Bulletin, No. 20, page 19, dated May 14, 1934; C. B. XIII–1, page 451, January–June, 1934.) In the instant case the Government imposed the tax on C. A. Burnette Co. (the customs slaughterer).

Refund statute.—In 1936 the Agricultural Adjustment Act was held unconstitutional in *United States* v. *Butler* (297 U. S., 1 [Ct. D. 1070, C. B. XV–1, 421 (1936)]), and thereafter Congress enacted Title VII of the Revenue Act of 1936 which provided for a refund of the processing taxes. (49 Stat., 1747.) Heretofore we have discussed the several provisions of this refund statute. (*F. & F. Laboratories* v. *Commissioner*, 104 Fed. (2d), 563 [Ct. D. 1418, C. B. 1939–2, 396]; *Oswald Jaeger Baking Co.* v. *Commissioner*, 108 Fed. (2d), 375 [Ct. D. 1455, C. B. 1940–1, 266], certiorari denied, 60 S. C., 723.) Upon further consideration we find no reason for receding from what we there said. We held in those cases that the statute restricted refunds to the particular processor who alone was obligated to pay the processing tax under the taxing statute.

Clearly this statute authorizes refunds to any processor who was obligated under the Agricultural Adjustment Act to pay the processing tax and can show that he did not pass the tax burden on to others. (Section 902, 49 Stat., 1747.) But, as far as it is pertinent here, the statute arranges the claims of taxpayers under the taxing statute into two classes and then applies separate enforcement procedures to each class of claims. The claims are classified as follows: (1) processing tax refund claims, or claims of taxpayers who paid taxes upon the processing of commodities used in their own business; and (2) custom processing tax refund claims, or claims of taxpayers who paid taxes with respect to the processing of commodities for customers for a charge or fee. (Section 902, 49 Stat., 1747; section 913(b), 49 Stat., 1754; article 101 (*h*), (*i*), (*k*), Treasury Regulations 96, promulgated under the Revenue Act of 1936.) In this regard the Commissioner has provided that claims be filed on separate forms; claim (1) on P. T. Form 79; and claim (2) on P. T. Form 78. (Section 903, 49 Stat., 1747; articles 501 and 601, Treasury Regulations 96.) The enforcement procedures selected are as follows: for the enforcement of claim (1), from Commissioner to Board of Review to the appellate courts (section 906, 49 Stat., 1748); for the enforcement of claim (2), from Commissioner to district court or Court of Claims to the appellate courts (sections 904 and 905, 49 Stat., 1748).

Conclusions.—We have studied the statutes and now we can answer the problem. The taxing statute taxes the first domestic processor and in the case of hogs this person is the slaughterer, the one who performs the initial processing operation. It does not require that the slaughterer be also a packer in his own right before he qualifies as the first domestic processor and taxpayer. It is not concerned with the number of processing operations but with the first processing operation. The person who performs the slaughtering—he may also perform the subsequent processing operations (packer) or he may specialize in killing only (the independent abattoir)—is the first domestic processor and taxpayer under the taxing statute. In the instant case C. A. Burnette Co. was engaged in the special business of slaughtering hogs for others—a professional killer of hogs. This company slaughtered petitioner's hogs as an independent contractor and paid the processing tax to the Government, and was the first domestic processor and taxpayer under the Agricultural Adjustment Act.

Moreover the refund statute recognized the claim of the C. A. Burnette Co. type of claimant [class (2)] and authorizes a refund of the taxes paid, if the claimant can show it bore the tax burden. Of course C. A. Burnette Co. could not recover under the statute, for it passed on the burden. Assuming, however, that petitioner were the proper tax claimant, it would be a claimant in class (2) under the refund statute. A substantially identical case arose in the Fifth Circuit, and the court there said: "The Board of Review was given jurisdiction to review only claims of taxpayers who paid processing taxes upon the processing of commodities used in their own business. The amount sought to be recovered in this action represents taxes paid with respect to the processing of an agricultural commodity for customers for a charge or fee, and the Board of Review had no jurisdiction to review the Commissioner's disallowance of the claim." (*Arabi Packing Co.* v. *Commissioner*, 109 Fed. (2d), 278, 279, certiorari denied, June 6, 1940.) We agree with the quoted statement; the Board of Review has no jurisdiction over claims of class (2).

Nor does the refund statute violate due process in its application to petitioner. If petitioner was not the first domestic processor and taxpayer under the Agricultural Adjustment Act, it had no right to a refund. In failing to provide a refund to petitioner in such a case, the refund statute did not violate due process.

The decision of the Board of Review should be affirmed.

Affirmed.

SECTION 903.—FILING OF CLAIMS.

REGULATIONS 96, ARTICLE 202: Facts and evidence in support of claim. 1941-26-10758 Ct. D. 1520

PROCESSING TAX—REVENUE ACT OF 1936—DECISION OF COURT.

PETITION FOR REVIEW—CLAIM FOR REFUND—SUFFICIENCY—JURISDICTION OF BOARD OF REVIEW—CONSTITUTIONALITY OF STATUTE.

The United States Processing Tax Board of Review did not err in dismissing a petition for determination upon its merits of a claim for refund of processing taxes paid where the taxpayer, although filing its claim on the prescribed form, elided the paragraph relating to the amount of the tax borne by it and stated that it was impossible to determine and prove how much of the tax, if any, was not absorbed by the taxpayer. Such a claim did not meet the requirements of article 202 of Regulations 96. The Board of Review has no original jurisdiction, and was without authority under the provisions of Title VII of the Revenue Act of 1936 to entertain a petition on its merits where the refund claim was not complete. The taxpayer's conclusion that it was impossible to determine and prove how much of the tax was borne by it does not present a constitutional question.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

Tennessee Consolidated Coal Co., petitioner, v. *Commissioner of Internal Revenue, respondent.*

[117 Fed. (2d), 452.]

On petition to review an order of the United States Processing Tax Board of Review.

Before HICKS, ALLEN, and ARANT, Circuit Judges.

[February 6, 1941.]

OPINION.

HICKS, Circuit Judge: Petition to review an order of the United States Processing Tax Board of Review, dismissing a petition for the determination upon its merits of a claim for refund of $177.45 taxes paid upon the processing of hogs, under the provisions of the Agricultural Act declared invalid January 19, 1936, in *United States* v. *Butler* (297 U. S., 1 [Ct. D. 1070, C. B. XV-1, 421 (1936)], the claim having been disallowed by the Commissioner of Internal Revenue. According to the petition, taxes were paid during the period from September, 1933, to December, 1935.

The refund claim was filed under the provisions of Title VII of the Revenue Act of 1936 (sections 901-917, ch. 690, 49 Stat., 1648) which authorized refunds of amounts so collected under certain conditions and limitations and prescribed the procedure to be followed. The Commissioner disallowed the claim upon the ground, that it contained no allegation or evidence that petitioner had borne the burden of the tax and had not shifted it to others; and that it afforded no basis for a determination of the incidence of the tax and failed to conform to the provisions of sections 902 and 903 of the statute.

In its petition to the Board the petitioner not only took issue with the rulings of the Commissioner but insisted that the Commissioner erred in not holding that sections 902 and 903 of Title VII of the Revenue Act of 1936 were unconstitutional in so far as they purported to condition refund upon proof that the taxpayer had borne the burden of the tax. The Board dismissed the petition upon the ground that the refund claim failed to comply with the

provisions of the Act here involved and of the Treasury regulations promulgated thereunder.

Our question is, whether the order of dismissal was justified.

It is provided by section 902 that before the claimant is entitled to any refund he is required to establish to the satisfaction of the Commissioner in accordance with the prescribed regulations, or to the satisfaction of the Board, that he has borne the burden of the tax and has not been relieved thereof nor reimbursed therefor, nor shifted such burden directly or indirectly in the manner set out in section 902(a)(b). As a further prerequisite to the allowance of the claim, section 903 requires that the claim should be filed "in accordance with the regulations prescribed by the Commissioner with the approval of the Secretary. All evidence relied upon in support of such claim shall be clearly set forth under oath." Article 201 of applicable Treasury Regulations 96 provides that the claim for the refund of such tax shall be made on prescribed forms and be prepared in accordance with the instructions contained thereon and with the provisions of the regulations.

It must be kept in mind that the Government has a right to determine for itself [*United States* v. *Michel*, 282 U. S., 656, 659 [Ct. D. 310, C. B. X–1, 297 (1931)]; *Dismuke* v. *United States*, 297 U. S., 167, 171] by law and by proper regulations which have the force of law [*Maryland Cas. Co.* v. *United States*, 251 U. S., 342, 349] the conditions upon which it consents to refund the tax and it is just as clear that petitioner has not complied with the prerequisite conditions.

The refund claim was filed by the Board as Exhibit B to the petition. It was on P. T. Form 79 prescribed by the regulations but the form was not followed. In the printed affidavit stating the essential elements of the claim the petitioner elided the following paragraph:

"4. (*a*) That the amount of the burden of the processing tax on the processing of the commodity named above which was borne by the claimant as set forth in column 2 above is true and correct; that the claimant has not been relieved thereof nor reimbursed therefor nor shifted such burden, directly or indirectly, (1) through inclusion of such amount by the claimant, or by any person directly or indirectly under his control, or having control over him, or subject to the same common control, in the price of any article processed from such commodity; (2) through reduction of the price paid for such commodity; or (3) in any manner whatsoever; and that no understanding or agreement, written or oral, exists whereby he may be relieved of the burden of such amount, be reimbursed therefor, or may shift the burden thereof; and (*b*) that the data and statements submitted in and made a part of Schedule D are true and correct;"

In the space calling for computation and comparison of the average margin before, during and after the tax period to indicate the burden of the tax actually borne by it, the petitioner answered, "No such information available." In the space provided for a "Statement of Facts" tending to establish that it had borne the burden of the tax, the petitioner wrote,—

"It is impossible to determine and prove how much of the tax, if any, was not absorbed by the taxpayer.

"Taxpayer demands refund of the entire amount paid because the Supreme Court has held that it was illegally assessed and collected and because any attempt to condition or restrict the refund thereof, by requiring proof that the tax was absorbed by taxpayer, is unconstitutional and void."

It is too clear for extended discussion that petitioner did not file a "complete claim" as required by article 202 of the applicable regulations. It struck from the form matters of substance which the regulations require and which the Commissioner had a right to insist upon. It has failed to set forth clearly under oath any evidence upon which it relies in support of the claim. We think therefore that the order of the Board dismissing the petition upon the grounds indicated was clearly right. (*United States* v. *Felt & Tarrant Co.*, 283 U. S., 269 [Ct. D. 336, C. B. X–1, 431 (1931)]; *Tucker* v. *Alexander*, 275 U. S., 228 [T. D. 3973, C. B. VI–1, 287 (1927)]; *Maryland Cas. Co.* v. *United States*, supra; *Kings County Savings Institution* v. *Blair*, 116 U. S., 200; *Nichols* v. *United States*, 7 Wall., 122, 130; *Lee Wilson & Co.* v. *Commissioner*, 111 Fed. (2d), 313, 317 (C. C. A. 8).)

But petitioner insists, the validity of the claim for refund to one side, that its petition to the Board stated a good cause of action which should have been heard upon its merits.

The petition averred in substance that petitioner had borne the burden of the tax and had not been relieved therefrom or reimbursed therefor and had not shifted the burden directly or indirectly to others and that its claim for refund

had been disallowed by the Commissioner. We need not further recite the averments of the petition for the Board was without authority to entertain it. It had no original jurisdiction. By section 906(b) of the Act jurisdiction is conferred upon it "to review the allowance or disallowance of the Commissioner of a claim for refund and to determine the amount of refund due any claimant with respect to such claim * * *"; and by section 906(c) the petitioner upon its request is entitled to a hearing on the merits of his claim in whole or in part. The terms "claim" or "claim for refund" mean of course a valid claim under the statute and this only. (See *Lee Wilson & Co.* v. *Commissioner*, supra.)

Finally, it is urged that Title VII of the Revenue Act of 1936 is unconstitutional, in so far as it conditions a refund upon a showing that a taxpayer bore the burden of the tax when such proof is not available. Just what particular provision of the Constitution is thus violated is not pointed out.

But the petition which we are urged to consider without reference to the claim for refund does not aver "that such proof is not available." The statement in the claim to the effect that "it is impossible to determine and prove how much of the tax, if any, was not absorbed by the taxpayer" and the further statement "no such information available" were mere conclusions or inferences which the petitioner could not determine for itself. The question of "impossibility" or "availability" of proof was one for the reviewing authorities under a proper claim. "Constitutional questions are not to be decided hypothetically." (See *Anniston Mfg. Co.* v. *Davis*, 301 U. S., 337, 353 [Ct. D. 1234, C. B. 1937–1, 485].)

The order sought to be reviewed is affirmed.[1]

[1] Judge Arant concurred in the conference conclusion in this case but died before the opinion was prepared.

BANKHEAD COTTON CONTROL ACT OF 1934, AS AMENDED.

1941–14–10667
Ct. D. 1499

PROCESSING TAX—BANKHEAD COTTON CONTROL ACT, AS AMENDED—SECOND DEFICIENCY APPROPRIATION ACT—DECISION OF COURT.

1. TAX ON EXCESS COTTON PRODUCTION—PURCHASE OF TAX EXEMPTION CERTIFICATES—CLAIM FOR REFUND.

A cotton grower who purchased cotton tax exemption certificates through the Department of Agriculture in lieu of payment of the tax imposed by the Bankhead Cotton Control Act, as amended, on cotton produced in excess of his allotment, may not recover the amount paid for the certificates in an action against the United States based upon the rejection of a claim for refund. Congress has prescribed the condition that refunds are allowable only to the extent that the tax was paid in money, and satisfaction of tax liability by the purchase of exemption certificates is not considered a payment of the tax in money.

2. JURISDICTION OF COURT.

The district court is without jurisdiction, in the absence of fraud, to review the findings of fact and conclusions of law of the Commissioner of Internal Revenue upon the merits of a claim, filed by a cotton grower after the Bankhead Cotton Control Act was declared unconstitutional, for the refund of amounts paid for tax exemption certificates. The Second Deficiency Appropriation Act, approved June 25, 1938, specifically prohibits the maintenance of such an action.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

T. J. Cook, appellant, v. *United States of America, appellee.*
[115 Fed. (2d), 463.]

Appeal from the District Court of the United States for the Middle District of Alabama.

Before FOSTER, HOLMES, and MCCORD, Circuit Judges.

[November 15, 1940.]

OPINION.

HOLMES, Circuit Judge: During the years 1934 and 1935, appellant (plaintiff below) was a grower of cotton in Alabama. He produced more cotton than was allotted to him under certain acreage-reduction contracts which he had entered into with the United States, and became subject to a tax on his excess production in the sum of 5 cents per pound. In lieu of the payment of this tax he purchased, through the United States Department of Agriculture, cotton exemption certificates, paying therefor approximately 4 cents per pound.

After the Agricultural Adjustment Act and the Bankhead Cotton Control Act were declared unconstitutional,[1] appellant duly filed claim for the amount of payments made by him for such exemption certificates. His claim was rejected, and this suit was brought by him against the United States to recover the amount of said claim. A motion to dismiss the complaint was made by the defendant, which was sustained by the court below on the grounds that (1) the complaint showed on its face that the court lacked jurisdiction of the subject matter, (2) the United States had not consented to be sued upon the claim set forth in the complaint, and (3) the provisions of the Second Deficiency Appropriation Act, approved June 25, 1938, specifically prohibited the maintenance of this action.

[1] *United States* v. *Butler* (297 U. S., 1 [Ct. D. 1070, C. B. XV–1, 421 (1936)]); *United States* v. *Lee Moor* (93 Fed. (2d), 422).

It is well settled that the United States Government is not suable as of common right, and the party who sues it must bring his case within the authority of some Act of Congress or the court can not exercise jurisdiction over it.[2]

Recognizing this rule, the appellant points to the Tucker Act, approved March 3, 1887 (ch. 359, 24 Stat., 505), and the Second Deficiency Appropriation Act, approved June 25, 1938. The Tucker Act is general in its nature, and must give way to special statutes covering the particular cases. The Federal courts, other than the Supreme Court, do not derive their jurisdiction from the Constitution of the United States, but exercise only such powers as Congress, within constitutional limits, confers upon them. So long as it does not expand that jurisdiction beyond such limitations, the Congress may give, withhold, or restrict that jurisdiction as it sees fit.[3] Courts created by statute must look to the statute as the warrant of their authority, and even an implied repeal of it leaves the courts powerless to decide pending cases.[4]

If it be conceded that the Tucker Act gives jurisdiction in this class of cases (which we do not decide), it was taken away in this particular case by the provisions of the Second Deficiency Appropriation Act, supra, which provided that, in the absence of fraud, all findings of fact and conclusions of law of the Commissioner of Internal Revenue upon the merits of any such claim for refund, and the mathematical calculations made in connection therewith, should not be subject to review by any court or by any officer, employee, or agent of the United States.

Treasury Decision No. 4850 [C. B. 1938–2, 476], duly promulgated, provides that refunds will be allowed only to the extent that the tax, penalty, or interest was paid in money, and that the satisfaction of tax liability by the surrender or use of tax exemption certificates, tax payment warrants, or tax exemption stamps is not considered a payment of the tax in money.

The United States Government is under no obligation to provide a remedy through the courts against itself.[5] The Congress having prescribed the conditions applicable to refunds of amounts collected under the Bankhead Cotton Control Act, these conditions must be strictly followed.[6]

In the case before us, appellant paid no tax, in money or otherwise, to the collector of internal revenue. He had the option of paying the tax in cash to such collector in his district on his excess lint cotton grown in 1934 and 1935 (as was done in *United States* v. *Lee Moor*, 93 Fed. (2d), 422); but, for reasons presumably deemed wise by him, he chose to purchase tax exemption certificates to cover the ginning of his excess cotton, and, accordingly, he received the ginner's certificate that the cotton was free of any tax lien or claim. He was thereby enabled to gin and sell his excess lint cotton without paying the tax imposed by the aforesaid Act.

Not only did Congress expressly prohibit the refund of amounts not paid as a tax in money to a collector of internal revenue, but it further provided that, in the absence of fraud, all findings of fact and conclusions of law of the Commissioner of Internal Revenue upon the merits of any such claim for refund should not be subject to review by any court. Appellant alleges the filing of a proper claim for refund and its rejection by appellee. This amounts to an allegation that appellant's claim for refund, required to be filed by the provisions of the Act, was rejected by the Commissioner of Internal Revenue upon its merits. Therefore, the court below, since the complaint contained no allegation of fraud, was without jurisdiction to review the Commissioner's findings of fact and conclusions of law upon the merits of appellant's claim. The judgment of the district court is affirmed.

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[2] *United States* v. *Clark* (8 Pet., 436, 444); *Reid* v. *United States* (211 U. S., 529); *United States* v. *Michel* (282 U. S., 656 [Ct. D. 310, C. B. X–1, 297 (1931)]); *Munroe* v. *United States* (303 U. S., 36).

[3] *Sheldon* v. *Sill* (8 How., 441); *De Groot* v. *United States* (5 Wall., 419); *Case of Sewing Machine Companies* (18 Wall., 553); *Ex Parte Robinson* (19 Wall., 505); *Stevenson* v. *Fain* (195 U. S., 165); *Kentucky* v. *Powers* (201 U. S., 1); *Ex Parte Wisner* (203 U. S., 449); *Kline* v. *Burke Construction Co.* (260 U. S., 226); *Gillis* v. *California* (293 U. S., 62); *Aetna Life Ins. Co.* v. *Haworth* (300 U. S., 227).

[4] *Insurance Co.* v. *Ritchie* (5 Wall., 541); *The Assessor* v. *Osborne* (9 Wall., 567); *Hallowell* v. *Commons* (239 U. S., 506); *Smallwood* v. *Gallardo* (275 U. S., 56).

[5] *United States* v. *Babcock* (250 U. S., 328).

[6] *Cheatham* v. *United States* (92 U. S., 85); *Stephens* v. *Monongahela Bank* (111 U. S., 197); *Medbury* v. *United States* (173 U. S., 492); *Parish* v. *McVeagh* (214 U. S., 124); *Rock Island, etc., R. R.* v. *United States* (254 U. S., 141 [Ct. D. 2, C. B. 4, 342 (1921)]); *Luckenbach S. S. Co.* v. *United States* (272 U. S., 533); *United States* v. *Michel* (282 U. S., 656 [Ct. D. 310, C. B. X–1, 297 (1931)]).

BITUMINOUS COAL TAX.

REGULATIONS 98 (1937), ARTICLE 11: Effective date. 1941–24–10748
T. D. 5053

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER C, PART 311.—BITUMINOUS COAL TAX.

Article 11, Regulations 98 (1937 edition), as amended and as made applicable to the Internal Revenue Code, further amended to conform to Public Law 34, Seventy-seventh Congress.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

In order to conform Regulations 98 [Part 311, Title 26, Code of Federal Regulations], relating to the taxes on the sale or other disposal of bituminous coal imposed under the Bituminous Coal Act of 1937 as made applicable to the Internal Revenue Code (53 Stat., Part 1; 26 U. S. C., Sup. V) by Treasury Decision 4885, approved February 11, 1939 [C. B. 1939–1 (Part 1), 396] [Chapter 1, note, Title 26, Code of Federal Regulations, 1939 Sup.], to the provisions of the Act approved April 11, 1941 (Public Law 34, Seventy-seventh Congress), such regulations are amended as follows:

PARAGRAPH 1. There is inserted immediately preceding article 11 [section 311.11, Title 26, Code of Federal Regulations], as amended by Treasury Decision 4742, approved June 22, 1937 [C. B. 1937–1, 348], the following:

Public Law 34, Seventy-seventh Congress. Approved April 11, 1941.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 19 of the Bituminous Coal Act of 1937 (relating to termination of the Act) is amended to read as follows:

"SEC. 19. This Act shall cease to be in effect (except as provided in section 13 of the Revised Statutes) and any agencies and offices established under, or to engage in the administration of, this Act shall cease to exist at 12:01 a. m., April 26, 1943."

(b) Section 3527 of the Internal Revenue Code (relating to termination of the bituminous coal taxes) is amended to read as follows:

"SEC. 3527. TERMINATION OF TAX.

"The taxes imposed by this chapter shall not apply to the sale or other disposal, after April 25, 1943, of bituminous coal."

PAR. 2. Article 11, as amended by Treasury Decision 4742, is amended to read as follows:

The taxes attach to sales or other disposals of bituminous coal made by the producer thereof on and after June 21, 1937, but do not attach to such sales or other disposals after April 25, 1943.

(This Treasury decision is prescribed under the authority contained in section 3521 of the Internal Revenue Code, 53 Stat., 431

(26 U. S. C., Sup. V, 3521), section 3791 of the Internal Revenue Code, 53 Stat., 467 (26 U. S. C., Sup. V, 3791), and the Act approved April 11, 1941 (Public Law 34, Seventy-seventh Congress).)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved June 10, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register June 12, 1941, 11.26 a. m.)

ALCOHOL TAX.

SUBCHAPTER C.—MISCELLANEOUS EXCISE TAXES.—PRODUCTION, FORTIFICATION, TAX-PAYMENT, ETC., OF WINE.

REGULATIONS 7 (1937), ARTICLE XXIV: Tax payment of wines. 1941–5–10584 T. D. 5033

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER C, PART 178.—PRODUCTION, FORTIFICATION, TAX-PAYMENT, ETC., OF WINE

Amending Regulations No. 7.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To District Supervisors, Collectors of Internal Revenue, and Others Concerned.

By virtue of and pursuant to the provisions of sections 3030(b)1, 3040, 3176, and 3301 of the Internal Revenue Code, paragraph 108 of Regulations No. 7 (section 178.108, Title 26, Code of Federal Regulations) is hereby amended to read as follows:

PAR. 108. *Tax-payment by stamp.*—Whenever the proprietor proposes to tax-pay and remove wine, he shall, prior to such removal, securely affix to each cask, barrel, or other immediate container (except bottles of a capacity of 1 gallon or less) or to each case or other shipping container (except railroad tank cars), stamps denoting payment of the internal revenue tax thereon. The stamps shall be affixed to the Government head of each package or side of each case. When removal is made in a tank truck, the stamps shall be affixed to a suitable board fastened to the truck in a permanent manner. The stamps must be affixed with a good adhesive. In the case of wooden containers, tacks or staples shall be used in addition to the adhesive. The proprietor shall cancel the stamps by indelibly writing or stamping thereon or perforating his name or initials and the date of cancellation. Upon being affixed and canceled a coating of transparent varnish or shellac, or glue that does not discolor the stamps and that affords protection against moisture, erasure, and removal equal to that afforded by varnish or shellac, must be applied over the stamps. The number of bottles and the size of each bottle in a case of champagne, sparkling wine, or artificially carbonated wine, must be stenciled or marked on the case.

TIMOTHY C. MOONEY,
Acting Commissioner of Internal Revenue.

Approved January 24, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register January 28, 1941, 10.18 a. m.)

MISCELLANEOUS RULINGS.

EXCESS PROFITS TAX.

1941–12–10655
T. D. 5043

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 30.—EXCESS PROFITS TAX.

Regulations relating to allowance of excess profits credit and information to be included in returns filed under the Excess Profits Tax Act of 1940, as amended by the Excess Profits Tax Amendments of 1941.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

By reason of the enactment of the Excess Profits Tax Amendments of 1941 (Public Law 10, Seventy-seventh Congress), approved March 7, 1941 [page 535, this Bulletin], the following regulations are hereby prescribed:

SECTION 30.1. *Excess profits credit; allowance.*—The Excess Profits Tax Act of 1940 provides two methods for computing the excess profits credit: (1) the income method under which the credit is computed as provided in section 713, and (2) the invested capital method under which the credit is computed as provided in section 714. The Excess Profits Tax Amendments of 1941 provide that, in the case of the following corporations, the excess profits credit for any taxable year shall be the credit based upon income, computed as provided in section 713, or the credit based upon invested capital, computed as provided in section 714, whichever credit results in the lesser tax for the taxable year for which the tax is being computed:

(*a*) A domestic corporation which was actually in existence before January 1, 1940.

(*b*) A domestic corporation which is an "acquiring corporation" within the meaning of section 740 of Supplement A and which was constructively in existence at the beginning of its base period.

(*c*) A foreign corporation (1) which is engaged in trade or business within the United States, or has an office or place of business therein, at any time during the taxable year; (2) the first taxable year of which for the purposes of the excess profits tax begins on any date in 1940; (3) which was in existence on the day 48 months prior to such date; and (4) which at any time during each of the taxable years in such 48 months was engaged in trade or business within the United States, or had an office or place of business therein. As to what constitutes being engaged in trade or business within the United States, see section 19.231–1 of Regulations 103.

If a taxpayer disclaims in its return for a particular taxable year the use of either credit, the credit so disclaimed shall not, for the purposes of the internal revenue laws, be applicable to the computation of the tax for the taxable year with respect to which the disclaimer is made.

A domestic corporation which was not actually in existence before January 1, 1940, and which was not constructively in existence on the date of the beginning of its base period, and a foreign corporation which does not meet the requirements of (*c*) above, are required to compute their credit under the invested capital method provided in section 714. (Section 62, 53 Stat., 32, 26

U. S. C., Sup. 62; sections 13, 14, 15, Excess Profits Tax Amendments of 1941, Public Law 10, Seventy-seventh Congress.)

SEC. 30.2. *Average base period net income of acquiring corporation.*—Section 742 of the Excess Profits Tax Act of 1940 provides rules for the computation of the average base period net income in the case of certain corporations which are "acquiring corporations" within the meaning of section 740. The Excess Profits Tax Amendments of 1941 provide that every acquiring corporation which was itself actually in existence before January 1, 1940, shall have an election to compute its average base period net income under either of the two following methods:

(*a*) The average base period net income computed under section 713 solely with reference to the taxpayer's own base period experience, without reference to the base period experience of any of the taxpayer's component corporations; or

(*b*) The average base period net income computed under section 742 with reference to the base period experience of the taxpayer and each qualified component corporation.

The election shall be made in the excess profits tax return for the particular taxable year. An election once made is irrevocable for a particular taxable year, but a new election is granted for each succeeding taxable year. An acquiring corporation which was merely constructively in existence before January 1, 1940, by reason of the provisions of section 740, is required, in every case, to compute its average base period net income under section 742. (Section 62, 53 Stat., 32, 26 U. S. C., Sup., 62; section 15, Excess Profits Tax Amendments of 1941, Public Law 10, Seventy-seventh Congress.)

SEC. 30.3. *Information required in returns.*—Any taxpayer which is entitled to have its excess profits credit computed under section 713 or section 714, whichever credit results in the lesser excess profits tax, is required, even though it has filed old Form 1121, to file a return on Form 1121 (revised March, 1941), and such return shall (unless the taxpayer states therein that it disclaims the use of one of the credits) contain computations of the credits computed under section 713 and section 714 and the excess profits net income computed with the credit under section 713 and the excess profits net income computed with the credit under section 714, and shall contain all the information required by such revised form and by these regulations with respect to such computations. A taxpayer stating in its return that it disclaims the use of one of the credits in the computation of the excess profits tax for the taxable year may omit from the return the computation and information based upon such disclaimed credit. (Section 62, 53 Stat., 32, 26 U. S. C., Sup., 62; section 16, Excess Profits Tax Amendments of 1941, Public Law 10, Seventy-seventh Congress.)

SEC. 30.4. *Modification of prior regulations.*—Regulations 109 [page 69, this Bulletin] [Part 30, Title 26, Code of Federal Regulations 1941, Sup.] are hereby modified to the extent that they may be inconsistent with these regulations. (Section 62, 53 Stat., 32, 26 U. S. C., Sup., 62; sections 13, 14, 15, 16, Excess Profits Tax Amendments of 1941, Public Law 10, Seventy-seventh Congress.)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved March 15, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register March 18, 1941, 11.46 a. m.)

ALCOHOL TAX.

1941–7–10605
T. D. 5039

Amendments to basic permit procedure under Federal Alcohol Administration Act.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To District Supervisors and Others Concerned:

SECTION 1. By virtue of and pursuant to the provisions of the Federal Alcohol Administration Act, as amended (U. S. C. Sup., Title 27), section 3170 of the Internal Revenue Code (53 Stat., Part 1) and section 161 of the Revised Statutes (U. S. C., Title 5, section 22), Part 171 of Title 26 of the Code of Federal Regulations is hereby amended by striking out subsections "(*c*)" and "(*d*)" of section 171.4d thereof.

SEC. 2. By virtue of and pursuant to the provisions of the Federal Alcohol Administration Act, as amended (U. S. C. Sup., Title 27), section 3170 of the Internal Revenue Code (53 Stat., Part 1) and section 161 of the Revised Statutes (U. S. C., Title 5, section 22), Part 171 of Title 26 of the Code of Federal Regulations is hereby amended by adding to section 171.4d thereof the following new subsections:

(*c*) The hearing in any proceedings instituted under this section by the Deputy Commissioner shall be held by him, or by a hearing officer authorized by him, and at such time and place as he may designate. The hearing in any proceedings instituted under this section by any district supervisor shall be held by him, or by a hearing officer authorized by him, and at such time and place as he may designate, except that the time and place of any hearing within a district other than that of such supervisor shall be such time and place as may be designated by the district supervisor of the other district, who shall conduct the hearing or authorize a hearing officer to conduct it, and who shall certify for decision the record thereof to the district supervisor who instituted the proceedings. The time and place of any designated hearing may be changed upon agreement of the parties.

(*d*) Upon written application, the attendance and testimony of any person, or the production of documentary evidence, in proceedings instituted under this section may be required by personal subpena (Form 1644) or by subpena duces tecum (Form 1645). Subpenas may be issued by the Deputy Commissioner, or by any district supervisor, or by any officer or employee thereunto authorized by either the Deputy Commissioner or the district supervisor. Both the application and the subpena shall set forth the title of the proceedings, the name and address of the person whose attendance is required, the date and place of his attendance, and, if documents are required to be produced, a description thereof; and the application shall set forth sufficient facts to show the relevancy of the testimony and documents.

(*e*) Any officer instituting proceedings under this section, or authorized to conduct hearings in such proceedings, may order the taking of depositions in the proceedings at such time and place as he may designate before a person having the power to administer oaths. The testimony shall be reduced to writing by the person taking the deposition, or under his direction, and the deposition shall be subscribed by the deponent unless the subscribing thereof is waived in writing by the parties. Any person may be subpenaed to appear and depose and to produce documentary evidence in the same manner as witnesses at hearings.

(*f*) Citations, notices of disapproval of application, notices of hearing, orders, and all documents, other than subpenas, served in proceedings under this section, shall be served in person by any officer, employee, or agent of the Treasury Department, or by registered mail (with request for registry return receipt

EXCESS PROFITS TAX ON CORPORATIONS—SECOND REVENUE ACT OF 1940.

The excess profits tax imposed by the Second Revenue Act of 1940 applies to all corporations except the few classes specifically exempt by statute.

The excess profits tax is applicable to all taxable years beginning after December 31, 1939. (Section 710(a).)

A domestic corporation in existence before January 1, 1940, or (section 741) which was an acquiring corporation in existence on the date of the beginning of its base period within the meaning of section 740 (a) and (d) may elect to compute their excess profits credit and taxable excess profits under either the average earnings method or the invested capital method, provided a timely return is filed. (Section 712(a).) Certain foreign corporations, qualifying under section 712(b), may make a similar election subject also to filing of a timely return. In the case of all other corporations, domestic or foreign, the excess profits credit is computed on invested capital. (Section 712 (a) and (b).)

AVERAGE EARNINGS METHOD.

BASE PERIOD INCOME.

Under the average earnings method the tax is imposed on the excess of the income for the taxable year over the average income for four years, 1936 to 1939, inclusive, known as the base period computed in accordance with section 713(b) and after allowance of a specific exemption of $5,000 and unused excess profits credit from the preceding year. (Section 710 (b).)

For the purpose of ascertaining the amount of the base period income, the starting point is the normal-tax net income or the special-class net income, as the case may be, for the years 1936 to 1939, adjusted as follows:

ADD TO NORMAL-TAX INCOME.

1.* Long-term capital losses: Section 711(b)(1)(B).
2. Deductions from retirement or discharge of bonds and certain other obligations outstanding for more than 18 months: Section 711(b)(1)(D) i, ii, and iii.
3. Losses from fire, storms, shipwrecks, or other casualty, or from theft, to the extent not compensated for by insurance or otherwise: Section 711(b)(1)(E).
4. Demolition and abandonment losses, and loss of useful value of property to the extent not compensated for by insurance or otherwise: Section 711(b)(1)(E).
5. Repayment of processing taxes to vendee: Section 711(b)(1)(F).
6. Deductions for any claim, award, judgment or decree against the taxpayer, or interest thereon are excluded if, in the light of the taxpayer's business, it was abnormal for the taxpayer to incur a liability of such a character or, if the taxpayer normally incurred such liability, the amount of such liability in the taxable year was grossly disproportionate to the amount of such liability in the four previous taxable years: Section 711(b)(1)(G).
7. Expenses deducted as intangible drilling and development costs in connection with oil or gas wells, or mine development costs, are excluded if it was abnormal to incur liabilities of such a nature or, if normal to incur them, the amount thereof in the taxable year was grossly disproportionate to the amount of such liability in the four previous taxable years: Section 711(b)(1)(H).

SUBTRACT FROM NORMAL-TAX INCOME.

1. Federal income taxes, except the surtax on improper accumulation of surplus, under section 102: Section 711(b)(1)(A).
2.* Long-term capital gains: Section 711(b)(1)(B).
3.* Excess of gains over losses from sale or exchanges of depreciable assets held for more than 18 months: Section 711(b)(1)(B).
4. Income from retirement or discharge of bonds and certain other obligations outstanding for more than 18 months: Section 711(b)(1)(C).
5. Additional credit is allowed for any dividends received during the taxable year from domestic corporations in excess of the amount allowed as a credit for the income tax for the taxable year: Section 711(b)(1)(I).

* Computed as if section 23(g)(2), section 23(k)(2) and section 117 were part of the revenue law applicable to the taxable year, the excess profits net income of which is being computed, with the exception that the net short-term capital loss carry-over provided in subsection (e) of section 117 shall be applicable to the net short-term capital losses for taxable years beginning after December 31, 1934; but such exception shall not apply for any taxable year beginning before January 1, 1941.

INCOME OF TAXABLE YEAR.

For ordinary income tax purposes a corporation is subject to tax on its net income minus the credit provided in section 26(a), Internal Revenue Code, for interest on 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); and minus the credit for dividends received from domestic corporations, provided in section 26(b), I. R. C.

The excess profits net income is the above mentioned normal-tax net income adjusted in accordance with section 711(a)(1).

For the purpose of ascertaining the amount of the excess profits net income, the starting point is the normal-tax net income for the current year (1940), adjusted as follows:

ADD TO NORMAL-TAX NET INCOME.

1. Long-term capital losses: Section 711(a)(1)(B).

SUBTRACT FROM NORMAL-TAX NET INCOME.

2. Federal income taxes except surtax on improper accumulation of surplus under section 102: Section 711(a)(1)(A).
3. Long-term capital gains: Section 711(a)(1)(B).
4. Excess of gains over losses from the sale or exchange of depreciable assets held more than 18 months: Section 711(a)(1)(B).
5. Income from retirement or discharge of bonds and certain other obligations outstanding for more than 18 months: Section 711(a)(1)(C).
6. Income attributable to refunds of Agricultural Adjustment Act taxes: Section 711(a)(1)(D).
7. Bad debts recovered, related to deductions allowable for any taxable year beginning prior to January 1, 1940: Section 711(a)(1)(E).
8. Additional credit is allowed for dividends on stock of domestic corporations received during the taxable year from domestic corporations in excess of the amount allowed as a credit for the income tax for the taxable year: Section 711(a)(1)(F).
9. Amounts allocable to a year or years other than the taxable year, as attributable to such other year or years, if said amounts fall under items classified in section 721 (a) to (f) and if, in the light of the taxpayer's business, it is abnormal to derive income of such a class; or, if it is normal to derive such income, the item, includible in gross income, is grossly disproportionate to the gross income of the same class in the four previous taxable years: Section 721.

INVESTED CAPITAL METHOD.

FACTORS IN THE DETERMINATION OF INVESTED CAPITAL.

For the purpose of ascertaining the amount of invested capital on which the excess profits credit is based, the starting point is to determine the invested capital as of the beginning of the taxable year and that figure is increased or reduced by the prorated amount of new capital paid in, or withdrawn during the taxable year.

Invested capital as of the beginning of the taxable year is the sum of the equity invested capital and the borrowed invested capital.

The following items are included in equity invested capital:

1. Money paid in for stock, as paid-in surplus or as a contribution to capital: Section 718(a)(1).
2. Property (other than money) paid in for stock, as paid-in surplus or as a contribution to capital: Section 718(a)(2).
3. Distributions in stocks and rights: Section 718(a)(3).
4. Earnings and profits at beginning of taxable year: Section 718(a)(4).
5. Liquidations under section 112 (b)(6): Section 718(a)(5).

REDUCTIONS IN EQUITY INVESTED CAPITAL.

6. Distributions: Section 718(b) (1) and (2).
7. Earnings and profits or property paid in connection with nontaxable exchange under section 751(a): Section 718(b)(3).
8. Liquidations under section 112(b)(6) resulting in a loss: Section 718(b)(4).

BORROWED INVESTED CAPITAL.

Section 719(a) defines "borrowed capital" as the amount of the outstanding indebtedness, not including interest and other indebtedness of the taxpayer described in section 751(b), which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus, in certain contingencies, the amount which would be repaid to a foreign government covering advance payments refundable to the latter on cancellation of contract between such government and the taxpayer for articles, materials, or supplies, provided this amount has not been includible in gross income.

Borrowed capital is included in invested capital to the extent of 50 per cent: Section 719(b).

CAPITAL AFTER JANUARY 1, 1940.

Section 717 provides for computation of invested capital on a daily basis and section 716 provides that the aggregate of such invested capital for each day of the taxable year be averaged.

ADMISSIBLE AND INADMISSIBLE ASSETS.

Assets, the income from which is not taxable, are eliminated from the invested capital as inadmissible assets to the extent provided in section 720. These assets include stocks in corporations, except stock in a foreign personal holding corporation, and exempt securities unless the interest thereon is included in income: Section 720.

GOVERNMENT OBLIGATIONS AND INTEREST.

Section 711(a)(2)(G) provides that, if a taxpayer has so elected under section 720(d), the normal-tax net income shall be increased by the amount of interest on Federal, State, and local government obligations described in section 22(b)(4). Under section 720(d) if no such election is made then such assets are treated as inadmissible assets.

EXCESS PROFITS NET INCOME FOR THE TAXABLE YEAR.

For the purpose of ascertaining the amount of the excess profits net income under the invested capital method, the starting point is the normal-tax net income for the current year, adjusted as follows:

ADD TO NORMAL-TAX NET INCOME.

1. Interest deduction is decreased by an amount equal to 50 per cent of interest on indebtedness included as borrowed capital: Section 711(a)(2)(B).
2. Long-term capital losses: Section 711(a)(2)(D).
3. Exempt interest on Federal, State, and local government obligations, at the option of the taxpayer: Section 711(a)(2)(G).

SUBTRACT FROM NORMAL-TAX NET INCOME.

4. Additional credit is allowed for dividends on stock of domestic corporations or foreign corporations (except foreign personal holding corporations), received during the taxable year in excess of the amount allowed as a credit for the income tax for the taxable year: Section 711(a)(2)(A).
5. Federal income taxes, except the surtax on improper accumulation of surplus, under section 102, I. R. C.: Section 711(a)(2)(C).
6. Long-term capital gains: Section 711(a)(2)(D).
7. Excess of gains over losses from the sale or exchange of depreciable assets held for more than 18 months: Section 711(a)(2)(D).
8. Income from retirement or discharge of bonds and certain other obligations outstanding for more than 18 months: Section 711(a)(2)(E).
9. Refunds and interest on Agricultural Adjustment Act taxes: Section 711(a)(2)(F).
10. Bad debt recoveries related to deductions allowable for any taxable year beginning prior to January 1, 1940: Section 711(a)(2)(H).
11. Amounts allocable to a year or years other than the taxable year, as attributable to such other year or years, if such amounts fall under the items classified in section 721 (a) to (f) and if, in the light of the taxpayer's business, it is abnormal to derive income of such a class; or, if it is normal to derive such income, the item, includible in gross income, is grossly disproportionate to the gross income of the same class in the four previous taxable years: Section 721.

EXCESS-PROFITS CREDIT UNDER AVERAGE EARNINGS METHOD.

1. 95 per cent of the average base period net income (the average for the 4-year period after adjustments have been made), applicable to both foreign and domestic corporations: Section 713(a)(1)(A).
2. Plus 8 per cent of the net capital additions made in the year 1940, or less 6 per cent of the net capital reductions made in the year 1940: Section 713(a)(1) (B) and (C). This adjustment does not apply to foreign corporations: Section 713(a)(2).
3. Plus unused excess profits credit from the preceding year: Section 710(b)(3).
4. Specific exemption of $5,000: Section 710(b)(1).

TAX RATES.

A graduated scale of rates applies to all corporations without regard to whether the adjusted excess profits net income is computed under the average earnings method or the invested capital method: Section 710(a).

The excess-profits tax rates are as follows:

	Rate (per cent).
Up to $20,000.00	25
Next $30,000.00	30
Next $50,000.00	35
Next $150,000.00	40
Next $250,000.00	45
Over $500,000.00	50

EXCESS-PROFITS CREDIT UNDER INVESTED CAPITAL METHOD.

1. 8 per cent of the invested capital for the taxable year: Section 714.
2. Plus unused excess profits credit from the preceding year: Section 710(b)(3).
3. Specific exemption of $5,000: Section 710(b)(1).

Remarks: For the sake of simplicity in showing the distinction between the Average Earnings and Invested Capital Methods, this diagram does not attempt to cover the consolidated return feature of the Act nor the effect of Supplement "B" on the excess profits tax. For the same reason it does not cover the computation of invested capital in special cases under section 723 nor of foreign corporations and corporations falling within the purview of section 251 as affected by section 724. Likewise, procedure under section 726 relative to corporations completing contracts under the Merchant Marine Act of 1936; to corporations engaged in mining strategic metals under section 731; and to personal service corporations under section 725, is omitted.

card post-office Form 3811) to the last known address in the records of the Alcohol Tax Unit. A certificate of mailing and the registry return card (post-office Form 3811), or a certificate of personal service, shall be filed as part of the record in each case. Subpenas shall be served in person, and, when issued on behalf of the United States, service shall be made by an officer, employee, or agent of the Treasury Department.

(*g*) Any provisions of Regulations No. 1, Relating to the Issuance, Revocation, Suspension and Annulment of Basic Permits, which are inconsistent with the provisions of this section, are repealed to the extent of such inconsistency.

SEC. 3. These regulations shall take effect 15 days after the date of filing with the Division of the Federal Register, but shall not invalidate any act done prior to such effective date in conformity with regulations theretofore existing.

STEWART BERKSHIRE,
Deputy Commissioner of Internal Revenue.

Approved January 21, 1941.

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved February 12, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register February 13, 1941, 11.51 a. m.)

1941–24–10745
T. D. 5050

Revised standards of identity for brandy.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE.

To District Supervisors and Others Concerned:

SECTION 1. By virtue of and pursuant to the provisions of the Federal Alcohol Administration Act, as amended (U. S. C., Sup., Title 27), section 3170 of the Internal Revenue Code (53 Stat., part 1), and section 161 of the Revised Statutes (U. S. C., Title 5, section 22), Regulations No. 5, Relating to Labeling and Advertising of Distilled Spirits (27 C. F. R., part 5), are amended as follows:

Article II, section 21, class 4 of said regulations (27 C. F. R. 5.21) is amended to read:

Class 4.—Brandies.—"Brandy" is a distillate, or a mixture of distillates, obtained solely from the fermented juice, mash or wine of fruit, or from the residue thereof, distilled at less than 190° proof in such manner as to possess the taste, aroma and characteristics generally attributed to the product, and bottled at not less than 80° proof; and shall also include such distillates, aged for a period of not less than 50 years, and bottled at not less than 72° proof, in cases where the reduction in proof below 80° is due solely to losses resulting from natural causes during the period of aging. Brandy, or mixtures thereof, not conforming to any of the following standards shall be designated as "brandy," and such designation shall be qualified by a truthful and adequate statement of composition in direct conjunction therewith.

(*a*) "Fruit brandy" is brandy distilled solely from the juice or mash of whole, sound, ripe fruit, or from standard grape, citrus, or other fruit wine, with or without the addition of not more than 20 per cent by volume (calculated prior to the addition of water to facilitate distillation) of the lees of such wine, and shall include mixtures of such brandy with not more than 20 per cent (calculated on a

proof basis) of lees brandy. Fruit brandy, derived exclusively from grapes, shall be designated as "grape brandy" or "brandy." Fruit brandy, other than grape brandy, derived exclusively from one variety of fruit, shall be designated by the word "brandy" qualified by the name of such fruit (e. g., "peach brandy," "apple brandy," "orange brandy"), except that "apple brandy" may be designated "applejack." Fruit brandy derived from more than one variety of fruit shall be designated as "fruit brandy," qualified by a truthful and adequate statement of composition (e. g., "fruit brandy—a blend of 90 per cent grape brandy and 10 per cent blackberry brandy").

(*b*) "Cognac" or "Cognac (grape) brandy," is grape brandy distilled in the Cognac region of France, which is entitled to be so designated by the laws and regulations of the French Government.

(*c*) "Dried fruit brandy" is brandy that conforms to the standard for fruit brandy except that it has been derived from sound, dried fruit, or from the standard wine of such fruit. Brandy derived from raisins, or from raisin wine, shall be designated as "raisin brandy." Other brandies defined in this paragraph shall be designated in the same manner as fruit brandy from the corresponding variety or varieties of fruit except that the name of the fruit shall be qualified by the word "dried."

(*d*) "Lees brandy" is brandy distilled from the lees of standard grape, citrus, or other fruit wine, and shall be designated as "lees brandy," qualified by the name of the fruit from which such lees are derived.

(*e*) "Pomace brandy," or "marc brandy," is brandy distilled from the skin and pulp of sound, ripe grapes, citrus or other fruit, after the withdrawal of the juice or wine therefrom, and shall be designated as "pomace brandy," or "marc brandy," qualified by the name of the fruit from which derived. Grape pomace brandy may be designated as "grappa" or "grappa brandy."

(*f*) "Neutral brandy" is any brandy distilled on or after July 1, 1941, at more than 170° proof. Brandy so distilled shall be designated in the same manner as if distilled at a lower proof, except that the designation shall be qualified by the word "neutral" in the same size and kind of type, e. g., "neutral brandy," "neutral grape lees brandy," or "neutral grape pomace brandy."

(*g*) "Substandard" brandy shall bear as a part of its designation the word "substandard," and shall include—

(1) Any brandy distilled at not more than 170° proof from juice, mash or wine having a volatile acidity in excess of that prescribed for standard wine, and any brandy distilled at more than 170° proof from juice, mash or wine having a volatile acidity, calculated as acetic acid and exclusive of sulphur dioxide, in excess of 0.20 gram per 100 cubic centimeters (20° C.); measurements of volatile acidity under this subparagraph shall be calculated exclusive of water added to facilitate distillation.

(2) Any brandy which has been distilled from unsound, mouldy, diseased or decomposed juice, mash or wine, or which shows in the finished product any taste, aroma or characteristic associated with products distilled from such juice, mash or wine.

Article II, section 21, class 7 of said regulations (27 C. F. R. 5.21) is amended by changing subparagraph (*g*) thereof to read:

(*g*) Any brandy to the distilling material for which has been added any amount of sugar other than the kind and amount of sugar expressly authorized for the amelioration of standard wine.

Article III, section 34(*d*) of said regulations (27 C. F. R. 5.34) is amended to read:

(*d*) In the case of whisky (as defined in Article II, section 21, class 2) and American type whisky produced on or after March 1, 1938, and in the case of brandy produced on or after July 1, 1941, which, in whole or in part, is treated with wood chips through percolation or otherwise, during distillation, rectification, or storage, there shall be stated in direct conjunction with the class and type designation the phrase "colored and flavored with wood chips."

Article III, section 39(*b*) of said regulations (27 C. F. R. 5.39) is amended to read:

(*b*) *Statements of age for rum, brandy, Scotch, Irish, and Canadian whiskies, and blended Scotch, blended Irish, and blended Canadian whiskies.*—(1) Age

may, but need not, be stated on labels of rums, brandies, and blended or unblended Scotch, Irish, and Canadian whiskies, as defined in Article II of these regulations: *Provided*, That an appropriate statement with respect to age shall appear on the brand label in the case of any brandy not aged for a period of at least two years.

(2) If age is stated, it shall be substantially as follows: "This rum is —— years old;" "This brandy is —— years old;" "This whisky is —— years old;" the blanks to be filled in with the age of the youngest distilled spirits in the product.

SEC. 2. These regulations shall take effect July 1, 1941.

STEWART BERKSHIRE,
Deputy Commissioner of Internal Revenue.

Approved May 29, 1941.

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved June 6, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register June 9, 1941, 11.11 a. m.)

1941–24–10746
T. D. 5051

Amending the labeling and advertising regulations under the Federal Alcohol Administration Act, to prevent the misleading use of brand names, and for other purposes.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To District Supervisors and Others Concerned:

By virtue of and pursuant to the provisions of the Federal Alcohol Administration Act, as amended (U. S. C. Sup., Title 27), section 3170 of the Internal Revenue Code (53 Stat., part 1), and section 161 of the Revised Statutes (U. S. C., Title 5, section 22), Regulations No. 4, No. 5, and No. 7, relating to labeling and advertising of wine, distilled spirits, and malt beverages, respectively (27 C. F. R., parts 4, 5, and 7), are amended as follows:

Article II, section 20, of Regulations No. 5 (27 C. F. R. 5.20) is amended to read:

SEC. 20. *Application of standards.*—The standards of identity for the several classes and types of distilled spirits set forth herein shall be applicable only to distilled spirits for beverage or other nonindustrial purposes. Nothing contained in these standards of identity shall be construed as authorizing the nonindustrial use of any distilled spirits produced in an industrial alcohol plant, except that "alcohol" or "neutral spirits," as herein defined, may be so used if produced pursuant to the basic permit requirements of the Federal Alcohol Administration Act.

Article III, section 30(*b*), of Regulations No. 4 (27 C. F. R. 4.30) is amended to read:

(*b*) *Alteration of labels.*—(1) It shall be unlawful for any person to alter, mutilate, destroy, obliterate or remove any mark, brand, or label upon wine held for sale in interstate or foreign commerce or after shipment therein, except as authorized by Federal law, or except as provided in paragraph (2) of this

subsection: *Provided*, That the district supervisors of the Alcohol Tax Unit may, upon written application, permit additional labeling or relabeling of wine for purposes of compliance with the requirements of this article or of State law.

(2) No application for permission to relabel wine need be made in any case where there is added to the container, after removal from customs custody or from the premises where bottled or packed, a label identifying the wholesale or retail distributor thereof, and containing no references whatever to the characteristics of the product.

Article III, section 33, of Regulations No. 4 (27 C. F. R. 4.33), Article III, section 33, of Regulations No. 5 (27 C. F. R. 5.33), and Article II, section 23, of Regulations No. 7 (27 C. F. R. 7.23), are amended to read:

Brand names.—(*a*) *General.*—The product shall bear a brand name, except that if not sold under a brand name, then the name of the person required to appear on the brand label shall be deemed a brand name for the purpose of this article.

(*b*) *Misleading brand names.*—No label shall contain any brand name, which, standing alone, or in association with other printed or graphic matter, creates any impression or inference as to the age, origin, identity, or other characteristics of the product unless the Deputy Commissioner finds that such brand name, either when qualified by the word "brand" or when not so qualified, conveys no erroneous impressions as to the age, origin, identity, or other characteristics of the product.

(*c*) This section shall not operate to prohibit the use by any person of any trade name or brand of foreign origin not effectively registered in the United States Patent Office on August 29, 1935, which has been used by such person or his predecessors in the United States for a period of at least five years immediately preceding August 29, 1935: *Provided*, That if such trade name or brand is used, the designation of the product shall be qualified by the name of the locality in the United States in which produced, and such qualification shall be in script, type, or printing as conspicuous as the trade name or brand.

Article III, section 39(*h*), of Regulations No. 4 (27 C. F. R. 4.39), Article III, section 41(*e*), of Regulations No. 5 (27 C. F. R. 5.41), and Article II, section 29(*d*), of Regulations No. 7 (27 C. F. R. 7.29), are amended to read:

Flags, seals, coats of arms, crests, and other insignia.—Labels shall not contain, in the brand name or otherwise, any statement, design, device, or pictorial representation which the Deputy Commissioner finds relates to, or is capable of being construed as relating to, the armed forces of the United States, or the American flag, or any emblem, seal, insignia, or decoration associated with such flag or armed forces; nor shall any label contain any statement, design, device, or pictorial representation of or concerning any flag, seal, coat of arms, crest or other insignia, likely to mislead the consumer to believe that the product has been endorsed, made, or used by, or produced for, or under the supervision of, or in accordance with the specifications of the government, organization, family, or individual with whom such flag, seal, coat of arms, crest, or insignia is associated.

Article VI, section 64(*g*), of Regulations No. 4 (27 C. F. R. 4.64), Article VI, section 64(*g*), of Regulations No. 5 (27 C. F. R. 5.64), and Article V, section 54(*g*), of Regulations No. 7 (27 C. F. R. 7.54), are amended to read:

Flags, seals, coats of arms, crests, and other insignia.—No advertisement shall contain any statement, design, device, or pictorial representation of or relating to, or capable of being construed as relating to, the armed forces of the United States, or of the American flag, or of any emblem, seal, insignia, or decoration associated with such flag or armed forces; nor shall any advertisement contain any statement, device, design, or pictorial representation of or concerning any flag, seal, coat of arms, crest, or other insignia, likely to mislead the consumer to believe that the product has been endorsed, made, or used by, or produced for,

or under the supervision of, or in accordance with the specifications of the government, organization, family, or individual with whom such flag, seal, coat of arms, crest, or insignia is associated.

STEWART BERKSHIRE,
Deputy Commissioner of Internal Revenue.

Approved June 5, 1941.

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved June 11, 1941.

H. MORGENTHAU, Jr.,
Secretary of the Treasury.

(Filed with the Division of the Federal Register June 12, 1941, 11.26 a. m.)

REGULATIONS 10(1940), SECTIONS 185.18, 185.91, 185.474, etc. 1941–19–10712
T. D. 5044

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER C, PART 185.

Amending Regulations 10.

TREASURY DEPARTMENT.
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To District Supervisors, Collectors of Internal Revenue, and Others Concerned:

Pursuant to sections 2872, 2875, 2878, 2879, 2883, 2885, 2903, 2904, 2905, 2910, 2915, 3170, and 3176 of the Internal Revenue Code, Regulations 10 are hereby amended in these respects:

(1) All requirements concerning export storage warehouses and export storage rooms are revoked. This amendment will affect the following sections, among others, sections 185.18, 185.91, 185.474, 185.482, and 185.484;

(2) Except as they may affect bonds filed prior to the effective date of these regulations, all requirements relative to export storage bond, Form 654, are revoked. This amendment affects the following sections, among others, sections 185.52, 185.73, 185.91, 185.95, 185.103, 185.110, 185.111, 185.112, 185.120, 185.121, 185.131, 185.132, 185.133, 185.134, and 185.135;

(3) (*a*) Each proprietor of an internal revenue bonded warehouse who has outstanding on the effective date of these regulations on export storage bond, Form 654, may, as to spirits stored thereunder, substitute for the obligation thereof bond, Form 1571, covering his bonded warehouse, by filing with the district supervisor a consent of surety, Form 1533, on the latter bond, if such bond is in the maximum penal sum or in such penal sum as will cover the tax on all distilled spirits in the warehouse or in transit thereto, including spirits bottled for export; provided that, if bond, Form 1571, is not in the maximum penal sum and is insufficient to cover the tax on spirits bottled for export, the proprietor may file a new or additional bond, Form 1571, to cover the tax on such spirits;

(*b*) Each proprietor of an internal revenue bonded warehouse, who desires to receive, or deposit, for storage in his bonded warehouse on and after the effective date of these regulations distilled spirits bottled for export, must file with the district supervisor a consent of surety, Form 1533, extending the terms of the existing bond, Form 1571, to cover the tax on distilled spirits bottled for export to be stored in such bonded warehouse, if such bond is in the maximum penal sum or in such penal sum as will cover the tax on all distilled spirits in the warehouse or in transit thereto, including spirits bottled for export; provided that, if bond, Form 1571, is not in the maximum penal sum and is insufficient to cover tax on spirits bottled for export to be received, or deposited, for storage in the warehouse, the proprietor must file a new or additional bond, Form 1571, to cover the tax on such spirits;

(*c*) One consent of surety, Form 1533, may be furnished to cover both situations mentioned in paragraph (3) (*a*) and (*b*); and

(4) Sections 185.51, 185.359, 185.365, 185.366, 185.367, and 185.369 are amended to read as follows:

SEC. 185.51. *Transportation and warehousing bond, Form 1571.*—Every person desiring the establishment of an internal revenue bonded warehouse shall, upon filing his application, Form 27–D, execute bond on Form 1571, "Transportation and Warehousing Bond," in triplicate, in conformity with the provisions of Article XI, and file the same with the district supervisor. The penal sum of such bond shall be not less than the amount of internal revenue tax at the rate prescribed by law on the quantity of distilled spirits that will be stored in such warehouse and in transit thereto at any one time, including distilled spirits bottled for export, provided that the maximum penal sum of such bond shall not exceed $200,000 for each such warehouse. (*; Secs. 2872, 2879(c), I. R. C.)

SEC. 185.359. *Application.*—Whenever an owner desires to remove distiller's original packages of distilled spirits from an internal revenue bonded warehouse for bottling in bond for storage pending withdrawal of the bottled spirits for exportation, he shall execute Form 655, in triplicate. (*; Secs. 2903, 2904, 2910, I. R. C.)

SEC. 185.365. *Records.*—(*a*) *Report of packages removed for bottling.*—The storekeeper-gauger will report the removal of the spirits from the bonded warehouse for bottling in bond for export on his monthly return, Form 1513, and the bottling of the spirits on Form 1515 and Form 1516, in accordance with the regulations governing the bottling of distilled spirits in bond. When the spirits have been bottled and cased, they will be returned to the storage portion of the bonded warehouse. These spirits need not be maintained in a separate room or building, but shall be kept separate and apart from all other distilled spirits stored in the warehouse. The storekeeper-gauger shall report the quantity so deposited on Form 1516, in the statement, "Export Storage Transactions."

(*b*) *Report of cases filled and redeposited.*—After the distilled spirits have been bottled and the cases returned to the storage portion of the bonded warehouse, the storekeeper-gauger will execute his report of cases filled and deposited in the bonded warehouse in Part 5 of Form 655. One copy of the report, together with Form 1520 covering the regauge of the packages, will be forwarded to the district supervisor. Remnants remaining after bottling distilled spirits in bond for export shall be disposed of as provided in the regulations governing the bottling of distilled spirits in bond, and appropriate notation made on Forms 655 and 1515. (*; Secs. 2904, 2910, 2915, I. R. C.)

SEC. 185.366. *Transfer between warehouses.*—Whenever it is desired to transfer distilled spirits, which have been bottled in bond for export and which are stored in a bonded warehouse, to another internal revenue bonded warehouse for storage, prior to direct exportation or transportation for export, the proprietor of the receiving warehouse shall execute an application for transfer of the spirits on Form 236. If the transfer is to be made between bonded warehouses in the same district, Form 236 will be prepared in quintuplicate, and if the transfer is

to be made between bonded warehouses in different districts, Form 236 will be prepared in sextuplet. The applicant will enter all applicable data indicated by the form, and will also enter thereon the statement "To be received and deposited for storage for export." The Forms 236 will be filed and disposed of in accordance with section 185.298 or 185.312, as the case may be. The cases will be inspected, transferred, received, examined, and reported in the manner provided by Article XXXII, in so far as it relates to the transfer of spirits bottled in bond before tax payment. (*; Sec. 2875, I. R. C.)

EXPORTATION OF BOTTLED DISTILLED SPIRITS.

SEC. 185.367. *Application and bond.*—Whenever it is desired to withdraw bottled distilled spirits from the bonded warehouse, either for direct exportation or for transportation for export, the owner shall execute application on Form 206, in triplicate, in accordance with section 185.317. The request for regauge will not be executed. The applicant shall forward all copies of Form 206 to the district supervisor, together with a properly executed export bond in a sufficient penal sum, computed as prescribed in section 185.329, except that the application need not be accompanied by a bond if the applicant has on file with the district supervisor an approved continuing bond (Form 657 or 658) in a sufficient penal sum. (*; Secs. 2905, 3170, I. R. C.)

SEC. 185.369. *Records.*—When the spirits have been removed from the warehouse, the storekeeper-gauger shall make appropriate entries in Form 1516 in the statement "Export Storage Transactions," and the proprietor shall report the removal on Form 52–C. (*; Sec. 2904, I. R. C.)

These regulations shall be effective on and after the thirtieth day following approval.

TIMOTHY C. MOONEY,
Acting Commissioner of Internal Revenue.

Approved May 1, 1941.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

(Filed with the Division of the Federal Register May 5, 1941, 10.53 a. m.)

SECTION 511 OF THE MERCHANT MARINE ACT, 1936, AS AMENDED.

1941–6–10593
T. D. 5035

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 32.

General Order No. 38 of the United States Maritime Commission.—Regulations under section 511 of the Merchant Marine Act, 1936, as amended.*

TREASURY DEPARTMENT,
OFFICE OF THE SECRETARY OF THE TREASURY,
Washington, D. C.

UNITED STATES MARITIME COMMISSION,
Washington, D. C.

To Officers and Employees of the Treasury Department, the United States Maritime Commission, and Others Concerned:

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SECTION 32.0. *Introductory.*—The Act approved October 10, 1940 (Public, No. 840, Seventy-sixth Congress, third session), provides:

That title V of the Merchant Marine Act, 1936, as amended, is hereby amended by adding at the end thereof a new section to read as follows:

"SEC. 511. (a) When used in this section the term 'new vessel' means any vessel (1) documented or agreed with the Commission to be documented under the laws of the United States; (2) constructed in the United States after December 31, 1939, or the construction of which has been financed under titles V or VII of this Act, as amended, or the con-

*Sections 32.0 to 32.27 are issued under the authority contained in section 511 of the Merchant Marine Act, 1936, as added by the Act approved October 10, 1940 (Public, No. 840, Seventy-sixth Congress, third session), and section 3791 of the Internal Revenue Code (53 Stat., 467; 26 U. S. C., Sup., 3791).

struction of which has been aided by a mortgage insured under title XI of this Act as amended; and (3) either (A) of such type, size, and speed as the Commission shall determine to be suitable for use on the high seas or Great Lakes in carrying out the purposes of this Act, but not of less than two thousand gross tons or of less speed than twelve knots, unless the Commission shall determine and certify in each case that a vessel of a specified lesser tonnage or speed is desirable for use by the United States in case of war or national emergency, or (B) constructed to replace a vessel or vessels requisitioned or purchased by the United States.

"(b) For the purposes of promoting the construction of vessels necessary to carrying out the policy set forth in title I of this Act, any citizen of the United States who is operating a vessel or vessels in the foreign or domestic commerce of the United States or in the fisheries or owns a vessel or vessels being so operated, or who, at the time of purchase or requisition of the vessel by the Government, was operating a vessel or vessels so engaged or owned a vessel or vessels being so operated, may establish a construction reserve fund, for the construction or acquisition of new vessels, to be composed of deposits of proceeds from sales of vessels, indemnities on account of losses of vessels, earnings from the operation of vessels, and receipts, in the form of interest or otherwise, with respect to amounts previously deposited. Such construction reserve fund shall be established, maintained, expended, and used in accordance with the provisions of this section and rules or regulations to be prescribed jointly by the Commission and the Secretary of the Treasury.

"(c) In the case of the sale or actual or constructive total loss of a vessel, if the taxpayer deposits an amount equal to the net proceeds of the sale or to the net indemnity with respect to the loss in a construction reserve fund established under subsection (b), then, if the taxpayer so elects in his income-tax return for the taxable year in which the gain was realized, no gain shall be recognized to the taxpayer in respect of such sale or indemnification in the computation of net income for the purposes of Federal income or excess-profits taxes. For the purposes of this subsection no amount shall be considered as deposited in a construction reserve fund unless it is deposited within sixty days after it is received by the taxpayer except that in the case of amounts received on or before the date of enactment of this section or within sixty days after such date, the deposit may be made within one hundred and twenty days after the date of enactment of this section. As used in this subsection the term 'net proceeds' and the term 'net indemnity' mean the sum of (1) the adjusted basis of the vessel and (2) the amount of gain which would be recognized to the taxpayer without regard to this subsection.

"(d) The basis for determining gain or loss and for depreciation, for the purpose of Federal income or excess-profits taxes, of any new vessel constructed or acquired by the taxpayer in whole or in part out of the construction reserve fund shall be reduced by that portion of the deposits in the fund expended in the construction or acquisition of the new vessel which represents gain not recognized under subsection (c).

"(e) For the purposes of this section, (1) if the net proceeds of a sale or the net indemnity in respect of a loss are deposited in more than one deposit, the amount consisting of the gain shall be considered as first deposited; (2) amounts expended, obligated, or otherwise withdrawn shall be applied against the amounts deposited in the fund in the order of deposit; and (3) if any deposit consists in part of gain not recognized under subsection (c), any expenditure, obligation, or withdrawal applied against such deposit shall be considered to consist of gain in the proportion that the part of the deposit consisting of gain bears to the total amount of the deposit.

"(f) With respect to any taxable year, amounts on deposit on the last day of such year in a construction reserve fund in accordance with this section and with respect to which all the requirements of subsection (g) have been satisfied, to the extent that such requirements are applicable as of the last day of said taxable year, shall not constitute an accumulation of earnings or profits within the meaning of section 102 of the Internal Revenue Code.

"(g) The provisions of subsections (c) and (f) shall apply to any deposit in the construction reserve fund only to the extent that such deposit is expended or obligated for expenditure, in accordance with rules and regulations to be prescribed jointly by the Commission and the Secretary of the Treasury, under a contract for the construction or acquisition of a new vessel or vessels entered into within two years from the date of such deposit, and only if under such rules and regulations—

"(1) within such period of two years not less than 12½ per centum of the construction or contract price of the vessel or vessels is paid or irrevocably committed on account thereof and the plans and specifications therefor are approved by the Commission to the extent by it deemed necessary; and

"(2) in case of a vessel or vessels not constructed under the provisions of this title or not purchased from the Commission, (A) said construction is completed, within six months from the date of the construction contract, to the extent of not less than 5 per centum thereof (or in case the contract covers more than one vessel, the construction of the first vessel so contracted for is so completed to the extent of not less than 5 per centum) as estimated by the Commission and certified by it to the Secretary of the Treasury, and (B) all construction under such contract is completed with reasonable dispatch thereafter.

"(h) The Commissioner of Internal Revenue is authorized under rules and regulations to be prescribed jointly by the Secretary of the Treasury and the Commission to grant extensions of the period within which the deposits shall be expended or obligated or within which construction shall have progressed to the extent of 5 per centum of completion as provided herein, but such extension shall not be for an aggregate additional period in excess of two years with respect to the expenditure or obligation of such deposits or more than one year with respect to the progress of such construction.

"(i) Any such deposited gain or portion thereof which is not so expended or obligated within the period provided, or which is otherwise withdrawn before the expiration of such period, or with respect to which the construction has not progressed to the extent of 5 per centum of completion within the period provided, or with respect to which the Commission finds and certifies to the Secretary of the Treasury that, for causes within the control of the taxpayer, the entire construction is not completed with reasonable dispatch, if otherwise taxable income under the law applicable to the taxable year in which such gain was realized, shall be included in the gross income for such taxable year, except for the purpose of the declared value excess-profits tax and the capital stock tax. If any such deposited gain or portion thereof is so included in gross income for such taxable year, there shall (in addition to any other deficiency) be assessed, collected, and paid in the same manner as if it were a deficiency, an amount equal to 1.1 per centum of the amount of gain so included, such amount being in lieu of any adjustment with respect to the declared value excess-profits tax for such taxable year.

"(j) Notwithstanding any other provision of law, any deficiency in tax for any taxable year resulting from the inclusion of any amount in gross income as provided by subsection (i), and the amount to be treated as a deficiency under such subsection in lieu of any adjustment with respect to the declared value excess-profits tax, may be assessed or a proceeding in court for the collection thereof may be begun without assessment, at any time: *Provided, however*, That interest on any such deficiency or amount to be treated as a deficiency shall not begin until the date the deposited gain or portion thereof in question is required under subsection (i) to be included in gross income.

"(k) This section shall be applicable to a taxpayer only in respect of sales or indemnifications for losses occurring within a taxable year beginning after December 31, 1939, and only in respect of earnings derived during a taxable year beginning after December 31, 1939.

"(l) For the purposes of this section a vessel shall be considered as constructed or acquired by the taxpayer if constructed or acquired by a corporation at a time when the taxpayer owns at least 95 per

centum of the total number of shares of each class of stock of the corporation.

"(m) The terms used in this section shall have the same meaning as in chapter 1 of the Internal Revenue Code.

Section 905(a) of the Merchant Marine Act, 1936, as amended by ection 39(a) of the Act of June 23, 1938 (52 Stat., 964; 46 U. S. C., Sup., 1244(a)), provides:

(a) The words "foreign commerce" or "foreign trade" mean commerce or trade between the United States, its Territories or possessions, or the District of Columbia, and a foreign country.

Section 905(c) of the Merchant Marine Act, 1936, as amended by ection 39(b) of the Act of June 23, 1938 (49 Stat., 2016; 52 Stat., 64; 46 U. S. C., Sup., 1244(c)), provides:

(c) The words "citizen of the United States" include a corporation, partnership, or association only if it is a citizen of the United States within the meaning of section 2 of the Shipping Act, 1916, as amended (U. S. C., title 46, section 802), and, in the case of a corporation, partnership, or association operating a vessel on the Great Lakes, or on bays, sounds, rivers, harbors, or inland lakes of the United States the amount of interest required to be owned by a citizen of the United States shall be not less than 75 per centum.

Section 2 of the Shipping Act, 1916, as amended (41 Stat., 1008; 46 U. S. C., 802, 803), provides:

SEC. 2. (a) That within the meaning of this Act no corporation, partnership, or association shall be deemed a citizen of the United States unless the controlling interest therein is owned by citizens of the United States, and, in the case of a corporation, unless its president and managing directors are citizens of the United States and the corporation itself is organized under the laws of the United States or of a State, Territory, District, or possession thereof, but in the case of a corporation, association, or partnership operating any vessel in the coastwise trade the amount of interest required to be owned by citizens of the United States shall be 75 per centum.

(b) The controlling interest in a corporation shall not be deemed to be owned by citizens of the United States (a) if the title to a majority of the stock thereof is not vested in such citizens free from any trust or fiduciary obligation in favor of any person not a citizen of the United States; or (b) if the majority of the voting power in such corporation is not vested in citizens of the United States; or (c) if through any contract or understanding it is so arranged that the majority of the voting power may be exercised, directly or indirectly, in behalf of any person who is not a citizen of the United States; or (d) if by any other means whatsoever control of the corporation is conferred upon or permitted to be exercised by any person who is not a citizen of the United States.

(c) Seventy-five per centum of the interest in a corporation shall not be deemed to be owned by citizens of the United States (a) if the title to 75 per centum of its stock is not vested in such citizens free from any trust or fiduciary obligation in favor of any person not a citizen of the United States; or (b) if 75 per centum of the voting power in such corporation is not vested in citizens of the United States; or (c) if, through any contract or understanding it is so arranged that more than 25 per centum of the voting power in such corporation may be exercised, directly or indirectly, in behalf of any person who is not a citizen of the United States; or (d) if by any other means whatsoever control of any interest in the corporation in excess of 25 per centum is conferred upon or permitted to be exercised by any person who is not a citizen of the United States.

(d) The provisions of this Act shall apply to receivers and trustees of all persons to whom the Act applies, and to the successors or assignees of such persons.

Section 48 of the Internal Revenue Code (53 Stat., 26) in part provides:

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. "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.

Section 3791 of the Internal Revenue Code (53 Stat., 467) in part provides:

SEC. 3791. RULES AND REGULATIONS.

(a) AUTHORIZATION.—

(1) IN GENERAL.—* * * the Commissioner, with the approval of the Secretary, shall prescribe and publish all needful rules and regulations for the enforcement of this title.

(2) IN CASE OF CHANGE IN LAW.—The Commissioner may make all such regulations, not otherwise provided for, as may have become necessary by reason of any alteration of law in relation to internal revenue.

(b) RETROACTIVITY OF REGULATIONS OR RULINGS.—The Secretary, or the Commissioner with the approval of the Secretary, may prescribe the extent, if any, to which any ruling, regulation, or Treasury decision, relating to the internal revenue laws, shall be applied without retroactive effect.

Pursuant to the foregoing provisions of law, the following regulations are hereby prescribed and Treasury Decision 5023, General Order No. 35 of the United States Maritime Commission, promulgated November 29, 1940 [C. B. 1940-2, 429] [Part 32, Title 26, Code of Federal Regulations, 1940 Sup.], is hereby superseded.*

SEC. 32.1. *Definitions.*—As used in these regulations, except as otherwise indicated by the context:

(*a*) The term "Act" means the Merchant Marine Act, 1936, as amended;

(*b*) The term "statute" means section 511 of the Merchant Marine Act, 1936, as amended;

(*c*) The term "section" means one of the sections of these regulations;

(*d*) The terms "Commission" and "Maritime Commission" mean the United States Maritime Commission;

(*e*) The term "citizen" means a person who, if an individual, was born or naturalized as a citizen of the United States or, if other than an individual, meets the requirements of section 905(c) of the Act and section 2 of the Shipping Act, 1916, as amended;

(*f*) The term "taxpayer" means a citizen who has established or seeks to establish a construction reserve fund under the provisions of the statute and these regulations, and may include a partnership;

(*g*) The term "corporation" includes associations and joint stock companies;

(*h*) The term "stock" includes the share in an association or joint-stock company.

In so far as the computation and collection of taxes are concerned, other terms used in these regulations, except as otherwise indicated by the context, have the same meaning as in the Internal Revenue Code and the regulations thereunder.*

SEC. 32.2. *Scope of statute.*—The statute provides, under conditions specified, for the nonrecognition for income and excess-profits tax purposes of the gain realized from the sale or indemnification for loss of certain vessels. It also permits the accumulation of the proceeds of such sale or indemnification and of certain earnings without liability under section 102 of the Internal Revenue Code.

(For the normal application of section 102, see sections 19.102–1 to 19.102–4, inclusive, Regulations 103.)

The benefits of the statute are available to any citizen as defined in section 32.1(*c*), who during any taxable year beginning after December 31, 1939, owns and operates a vessel or vessels within the scope of section 32.3. Such benefits are also available to a citizen who owns a vessel or vessels, within the scope of section 32.3, operated by others. A citizen so operating such a vessel or vessels owned by any other person, although he can derive no benefit from the provisions relating to the nonrecognition of gain from the sale or loss of such vessel or vessels so owned, may establish a construction reserve fund in which he may deposit earnings from the operation of such vessel or vessels.

The statute applies only with respect to sales or losses of vessels within the scope of section 32.3 occurring within a taxable year beginning after December 31, 1939, or in respect of earnings derived from the operation of such vessels during a taxable year beginning after December 31, 1939. A loss to be within the statute must be an actual or constructive total loss. Whether there is a total loss, actual or constructive, will be determined by the Maritime Commission. As to what proceeds, earnings, or receipts may be deposited in the construction reserve fund, see sections 32.13 and 32.14. The loss of a vessel which occurs during a taxable year beginning prior to December 31, 1939, is not within the scope of the statute, even though the taxpayer is indemnified during a later year.*

SEC. 32.3. *Requirements as to operation.*—The statute applies with respect to vessels operated in the foreign or domestic commerce of the United States or in the fisheries. The foreign commerce of the United States includes commerce or trade between the United States (including the District of Columbia), the Territories and possessions which are embraced within the coastwise laws, and a foreign country or other Territories and possessions of the United States. The domestic commerce of the United States includes commerce or trade between ports of the United States and its Territories and possessions, embraced within the coastwise laws. The fisheries include the fisheries of continental United States and its Territories and possessions, except the Philippine Islands (see section 5, 39 Stat., 547; 48 U. S. C., 1003). The statute does not apply to vessels operated in the foreign commerce or fisheries of some country other than the United States.*

SEC. 32.4. *Application to establish fund.*—Any person claiming to be entitled to the benefits of the statute may make application, in writing, to the Commission for permission to establish a construction reserve fund. The application shall be in such form and substance as the Commission may prescribe and shall designate, among other things, the depository or depositories with which the applicant proposes to establish the said fund. The original application shall be executed and verified by the taxpayer or, if the taxpayer is a corporation, by one of its principal officers, and shall be accompanied by 11 copies when filed with the Commission.*

SEC. 32.5. *Tentative authorization to establish fund.*—Where the time between the receipt by the Commission of the application for permission to establish a construction reserve fund and the date prior to which an amount received from the sale or loss of a vessel must be deposited to come within the scope of the statute is insufficient to permit a determination of the eligibility of the applicant, the Commission may tentatively authorize the establishment of a construction reserve fund and the deposit of such amount therein. Such tentative authorization shall be subject to rescision by the Commission, if subsequently it is determined that the applicant is not entitled to the benefit of the statute, and, upon such determination, the fund shall be closed and all amounts on deposit therein shall be withdrawn.*

SEC. 32.6. *Establishment of fund.*—If the application is approved by the Commission, the Commission will adopt a resolution authorizing the establishment of a construction reserve fund with the depository or depositories designated by the taxpayer and approved by the Commission. The resolution will provide for joint control by the Commission and the taxpayer over such fund, will set forth the conditions governing the establishment and maintenance of the fund and the making of deposits therein and withdrawals therefrom, and will designate the representatives authorized to execute instruments of withdrawal on behalf of the Commission.

A certified copy of the resolution of the Commission will be furnished the taxpayer. If the taxpayer is a corporation, it shall promptly adopt, through its board of directors, a resolution satisfactory in form and substance to the Commission, authorizing the establishment and maintenance of the fund in

onformity with the action of the Commission. If the taxpayer is not a orporation it shall promptly execute an agreement with the depository satisactory in form and substance to the Commission to conform to the action f the Commission as set forth in the resolution. Certified copies of the esolutions of the Commission and of the taxpayer (if it is a corporation) ill be furnished to the depository by the Commission and the taxpayer espectively for its guidance in maintaining the fund and honoring instruments of withdrawal. The taxpayer, if a corporation, shall also furnish the ommission with a certified copy of its resolution, or if not a corporation, a uplicate oirginal of its agreement with the depository.*

SEC. 32.7. *Transactions prior to promulgation of these regulations.*—Where he taxpayer has complied with the requirements of the "Preliminary regulaions for establishment of construction reserve funds under section 511 of the lerchant Marine Act, 1936, as amended" (T. D. 5023—General Order No. 5 of the Commission), and, with the approval of the Commission, has made eposits authorized by the statute in such fund, the taxpayer shall submit to he Commission, promptly upon the promulgation of these regulations, the pplication required by section 32.4 hereof. If and when such application is pproved by the Commission, deposits and withdrawals shall be made, and he construction reserve fund shall be maintained in accordance with these egulations. If the application is not approved the fund shall be closed and ll amounts on deposit therein shall be withdrawn.

If, prior to the establishment of a construction reserve fund under these egulations, a taxpayer has made necessary payments under a contract, which atisfies the provisions of these regulations and the statute, for the construcion or acquisition of a new vessel, such taxpayer may, if subsequently uthorized to establish a construction reserve fund under these regulations, lraw against such fund as reimbursement for the amount, if any, of other unds which, with the approval or ratification of the Commission, the taxpayer ised prior to the establishment of the fund for the purpose of making such ecessary payments.*

SEC. 32.8. *Investment of funds in securities.*—Interest-bearing direct obligaions of the United States, or obligations fully guaranteed as to principal and nterest by the United States, may be deposited in the construction reserve fund n lieu of cash, and such obligations may also be purchased with cash on deposit n the fund. In instances where the taxpayer desires to deposit any other ecurities in the fund in lieu of cash, or to purchase such other securities with ash on deposit in the fund, the taxpayer shall make written application to the ommission and shall not consummate the transaction until the written consent f the Commission shall have been received. The application shall describe he securities fully. Every approval of such application by the Commission hall be conditioned upon agreement by the taxpayer forthwith to dispose of uch securities upon subsequent request by the Commission. Immediately upon he purchase of any securities for deposit in the fund, the taxpayer shall advise he Commission, giving the date of purchase, a description of the securities, and he price paid therefor (net, brokerage and other charges, and gross). Ordiarily the Commission will not approve the deposit in the fund in lieu of cash, r the purchase with cash on deposit in the fund, of securities not actively raded in on exchanges registered under the "Securities Exchange Act of 1934," r securities which are not legal for investment of trust funds.*

SEC. 32.9. *Valuation of securities in fund.*—In cases where securities are deposted in the fund in lieu of cash, or are purchased with cash on deposit in the und, the "market value" of such securities must not be less than the amount f cash in lieu of which they are so deposited or with which they are so purhased. For the purpose of determining the amount in the fund, the "market alue" of securities shall be determined in the following manner:

(*a*) In instances where no actual purchase is involved, such as the initial leposit of securities in the fund in lieu of cash, the last sales price thereof on he principal exchange on the day the deposit was made shall be deemed to be he "market value" thereof, or, if no such sales were made, the "market value" hereof will be determined by the Commission on such basis as it may deem o be fair and reasonable in each case.

(*b*) With respect to transactions involving the purchase of securities with ash on deposit in the fund, "market value" shall be the gross price paid adjusted for accrued interest), provided that if such securities are purchased otherwise than upon a registered exchange the price shall be within the range f transactions on the exchange on the date of such purchase, or, if there were

no such transactions, then the "market value" thereof will be determined by the Commission on such basis as it may deem to be fair and reasonable in each case.

If securities on deposit in the fund are replaced by cash from the general funds of the taxpayer, the amount of cash to be deposited in the fund in lieu thereof shall be not less than the amount at which such securities were valued at the time of their deposit in the fund.

Purchase money obligations secured by vessels sold or irrevocable commitments to finance the construction or acquisition of new vessels which are deposited in the construction reserve fund as provided in section 32.13 ordinarily will be considered as equivalent to their face value.*

SEC. 32.10. *Withdrawals from fund.*—Checks, drafts, or other instruments of withdrawal, after having been executed by the taxpayer, shall be forwarded to the Commission at Washington with appropriate explanation of the purpose of the proposed withdrawal, including properly certified invoices or other supporting papers. Such instruments of withdrawal, after counter-signature on behalf of the Commission, will ordinarily be forwarded to the payees.

Amounts obligated under a contract for the construction or acquisition of new vessels within the scope of the statute may not, so long as the contract continues in full force and effect, be withdrawn for a purpose other than the construction or acquisition of such new vessels.*

SEC. 32.11. *Time deposits.*—Deposits in the construction reserve fund not invested in securities may be placed in time deposits when, in the judgment of the taxpayer, it is desirable and feasible so to do.*

SEC. 32.12. *Election.*—As a prerequisite to nonrecognition of gain on the sale or loss of a vessel as provided by the statute, the taxpayer after establishing a construction reserve fund must make an election in his income tax return, or if a partnership in the partnership return of income, for the taxable year in which the gain is realized. The election shall be with respect to each vessel and shall be shown by a statement to that effect, submitted as a part of, and attached to, the return. The statement, which need not be on any prescribed form, shall set forth a computation of the amount of the realized gain, the identity of the vessel, whether it was sold or lost and the date of sale or loss, the sale price or full amount of indemnity, the amount and date of each payment of the sale price or indemnity, the basis for tax purposes, and any other data affecting the determination of the realized gain.

Deposit of an amount equal to the net proceeds of the sale or loss must be made within the period specified in section 32.15 of these regulations and may not be delayed beyond the specified period to await the execution or filing of a statement of election.*

SEC. 32.13. *Deposit of proceeds of sales or indemnities.*—The deposit required by the statute must be made in a construction reserve fund, established with a depository or depositories approved by the Commission and subject to the joint control of the Commission and the taxpayer. It is not necessary to establish a separate fund with respect to each vessel sold or lost. With respect to any vessel sold or lost, however, the deposit must be in an amount equal to the "net proceeds" of the sale or the "net indemnity" for the loss. By "net proceeds" and "net indemnity" is meant (1) the adjusted basis of the vessel plus (2) the amount of gain which would be recognized for tax purposes in the absence of the statute. Where the proceeds from the sale of a vessel include purchase money obligations, such obligations together with the entire collateral therefor, shall be deposited, with the remainder of the proceeds, in the construction reserve fund as a part of the "net proceeds." The depository shall receive payment of all amounts due on such purchase money obligations and such amounts shall be placed in the fund in substitution for the portion of the obligations paid. If the taxpayer so desires, he may deposit in the construction reserve fund cash or approved securities in an amount equal to the face value of any purchase money obligations in lieu of depositing such obligations.

In the case of the sale or loss of a vessel, the taxpayer must deposit the full amount of each payment (including cash, notes, or other evidences of indebtedness) as a single deposit in the construction reserve fund. A payment divided between two or more depositories will be regarded as a single deposit. Amounts received by the taxpayer prior to the date of consummation of the sale of the vessel shall be considered as having been received by the taxpayer at the time the sale is consummated.

Where a vessel is subject to a mortgage or other encumbrance at the time of its sale or loss and the taxpayer actually receives only an amount representing his

equity in such vessel, he shall deposit in the construction reserve fund the amount received and concurrently therewith other funds in an amount equal to the difference between the amount received and the "net proceeds" or "net indemnity." Such other funds may be in the form of cash, or, subject to the approval of the Commission, (1) interest-bearing securities, or (2) an irrevocable commitment to finance the construction or acquisition of the new vessel by an obligor approved by the Commission in an amount equal to the amount by which the "net proceeds" exceeds the cash or securities deposited in the fund.

In case of the sale or loss of several vessels, a deposit of the "net proceeds" or "net indemnity" with respect to one or more of the vessels is permissible. Where several vessels are sold for a lump sum the "net proceeds" allocated to each vessel shall be determined in accordance with any reasonable rule satisfactory to the Commissioner of Internal Revenue.

A deposit which is not provided for by the statute shall, without unreasonable delay, be eliminated from the fund and tax liability will be determined as though such deposit had not been made. (See section 32.22.)*

SEC. 32.14. *Deposit of earnings and receipts.*—A citizen may deposit all or any part of earnings derived from operation, within the scope of section 32.3, of a vessel or vessels owned either by himself or any other person. Such earnings may include payments received by an owner, as compensation for use of his vessel, from other persons by whom it is so operated. Earnings from other sources may not be deposited. Only earnings intended for construction or acquisition of new vessels may be deposited. The earnings deposited must be of taxable years beginning after December 31, 1939.

The earnings from operation of vessels which are eligible for deposit are the net earnings determined without regard to any deduction for depreciation, obsolescence, or amortization with respect to such vessels. Receipts from deposited funds, in the form of interest or otherwise, may be deposited. *

SEC. 32.15. *Time for making deposits.*—Deposits of amounts representing proceeds of the sale or indemnification for loss of a vessel must be made within 60 days after receipt by the taxpayer, except that amounts received on or before December 9, 1940, may be deposited not later than February 7, 1941. Earnings and receipts, within the scope of the statute, of taxable years beginning after December 31, 1939, may be deposited at any time. (See section 32.14.) *

SEC. 32.16. *Tax liability as to earnings deposited.*—Deposit in the construction reserve fund of earnings from operation of a vessel or vessels, or receipts, in the form of interest or otherwise, with respect to amounts previously deposited does not exempt the taxpayer from tax liability with respect thereto. Earnings and receipts deposited in a construction reserve fund established in accordance with the provisions of the statute and these regulations do not constitute an accumulation of earnings or profits within the meaning of section 102 of the Internal Revenue Code as long as the requirements of the statute and these regulations relative to the use of the fund in the construction or acquisition of new vessels are satisfied. For application of the statute in case earnings or receipts so deposited are later withdrawn for purposes other than the construction or acquisition of new vessels, or there is failure otherwise to comply with the statute or these regulations, see section 32.21.*

SEC. 32.17. *Allocation of gain for tax purposes.*—If the "net proceeds" of a sale or the "net indemnity" in respect of a loss are deposited in more than one deposit, the gain will be considered as first deposited. Amounts expended, obligated, or withdrawn will be applied against the amounts deposited in the order of deposit. If any deposit consists in part of gain not recognized under the statute, any expenditure, obligation, or withdrawal applied against such deposit will be considered to consist of gain in the proportion that the part of the deposit consisting of gain bears to the total amount of the deposit. If amounts on deposit in a construction reserve fund are expended, obligated, or withdrawn for construction or acquisition of new vessels, the portion thereof which represents gain will be applied in reduction of the basis of such new vessels for determining gain or loss, and for depreciation, for the purpose of Federal income or excess-profits taxes. If any amounts are withdrawn for purposes other than the construction or acquisition of new vessels, the portion thereof which represents gain, if otherwise constituting taxable income under the law applicable to the taxable year in which such gain was realized, will be included in the gross income for such taxable year, except for the purpose of the declared value excess-profits tax and the capital stock tax. (See section 32.22.)

The date funds are obligated under a contract for the construction or acquisition of a new vessel, rather than the date of payment from the fund, will determine the order of application against the deposits in the fund. When a contract for the construction or acquisition of a new vessel is entered into, amounts on deposit in the construction reserve fund will be deemed to be obligated to the extent of the amount of the taxpayer's liability under the contract. Deposits will be deemed to be so obligated in the order of deposit, each new contract obligating the earliest deposit not previously expended, obligated, or withdrawn. If the liability under the contract exceeds the amount in the construction reserve fund, the contract will be deemed to obligate, to the extent of that part of such excess not otherwise satisfied, the earliest deposit or deposits thereafter made.

Example: A taxpayer who makes his return on the calendar year basis sells a vessel in 1941 for $1,000,000, realizing a gain of $400,000. One hundred thousand dollars of the sale price is received in March, 1941, when the contract is signed, and the balance of $900,000 is received in June, 1941, on delivery of the vessel. The $1,000,000 is deposited in a construction reserve fund in July, 1941. In December, 1941, the taxpayer also deposits $150,000 representing earnings of that year. In 1942 he sells another vessel for $1,000,000, realizing a gain of $250,000. The sale price of $1,000,000 is received on delivery of the vessel in February, 1942, and deposited in the construction reserve fund in March, 1942. In September, 1942, the taxpayer purchases for cash out of the construction reserve fund a new vessel for $1,750,000. To the cost of this vessel must be allocated the 1941 deposits of $1,150,000 and $600,000 of the March, 1942, deposit. This leaves in the fund $400,000 of the March, 1942, deposit. The amount of the unrecognized gain to be applied against the basis of the new vessel is as follows: $400,000 gain represented in the 1941 deposits, plus the same proportion of the $250,000 gain represented in the March, 1942, deposit ($1,000,000) which the amount ($600,000) allocated to the vessel is of the amount of the deposit, *i. e.*, $400,000 plus $\frac{600,000}{1,000,000}$ of $250,000 or $150,000, a total of $550,000. This reduces the basis of the new vessel to $1,200,000 ($1,750,000 less $550,000).

In 1943 the taxpayer sells a third vessel for $3,000,000, realizing a gain of $900,000. The $3,000,000 is received and deposited in the construction reserve fund in June, 1943, making the total in the fund $3,400,000. In December, 1943, the taxpayer contracts for the construction of a second new vessel to cost a maximum of $3,200,000, thereby obligating that amount of the fund, and in June, 1944, receives permission to withdraw the unobligated balance amounting to $200,000. To the cost of the second new vessel must be allocated the $400,000 balance of the March, 1942, deposit and $2,800,000 of the June, 1943, deposit. The unrecognized gain to be applied against the basis of such new vessel is that proportion of the gain represented in each deposit which the portion of the deposit allocated to the vessel bears to the amount of such deposit, *i. e.*, $\frac{400,000}{1,000,000}$ of $250,000, or $100,000 plus $\frac{2,800,000}{3,000,000}$ of $900,000, or $840,000, making a total of $940,000. The $200,000 withdrawn is applied against the June, 1943, deposit and the portion thereof which represents gain will be recognized as income for 1943, the year in which realized. The computation of the recognized gain is as follows: $\frac{200,000}{3,000,000}$ of $900,000 or $60,000.*

SEC. 32.18. *Requirements as to new vessels.*—For the purposes of the statute and these regulations, the new vessel must be—

(1) documented under the laws of the United States when it is acquired by the taxpayer, or the taxpayer must agree that when acquired it will be documented under the laws of the United States;

(2) (*a*) constructed in the United States after December 31, 1939, or (*b*) its construction must have been financed under Title V or Title VII of the Act, or (*c*) its construction must have been aided by a mortgage insured under Title XI of the Act; and

(3) either (*a*) of such type, size, and speed as the Maritime Commission determines to be suitable for use on the high seas or Great Lakes in carrying out the purposes of the Act, but of not less than 2,000 gross tons or of less speed than 12 knots, except that a particular vessel may be of lesser tonnage or speed if the Maritime Commission determines and certifies that the particular vessel is desirable for use by the United States in case of

war or national emergency, or (*b*) constructed to replace a vessel or vessels requisitioned or purchased by the United States, in which event it must be of such type, size, and speed as to constitute a suitable replacement for the vessel requisitioned or purchased, but if a vessel already built is acquired to replace a vessel or vessels requisitioned or purchased by the United States, such vessel must meet the requirements set forth in subdivision (3)(*a*) of this paragraph.

A vessel will be deemed to be constructed after December 31, 1939, only if construction was commenced after that date. Subject to the provisions of this section, a new vessel may be newly built for the taxpayer, or may be acquired after it is built.

It is not necessary that vessels shall be replaced vessel for vessel. The new vessels may be more or less in number than the replaced vessels, provided the other requirements of this section are met.*

SEC. 32.19. *Contracts obligating deposits.*—A contract for the construction or acquisition of a new vessel entered into prior to October 10, 1940, or a contract which supersedes, amends, or supplements such a contract, is not within the scope of the statute. Unless otherwise authorized by the Commission, contracts for the construction of new vessels must be for a fixed price, or provide for a base price that may be adjusted for changes in labor and material costs up to but not exceeding 15 per cent of the base price. Plans and specifications for the new vessel or vessels must be approved by the Commission to the extent it deems necessary. Within two years from the date of any deposit in a construction reserve fund, unless extension is granted as hereinafter provided, such deposit must be obligated under a construction or purchase contract and at least 12½ per cent of the construction or contract price must be actually paid or irrevocably committed on account thereof. Amounts on deposit in a construction reserve fund will be deemed to be obligated for expenditure when a binding construction or purchase contract has been entered into and will be deemed to be irrevocably committed when due and payable in accordance with the terms of the contract of construction or acquisition. The Commissioner of Internal Revenue may, upon application and a showing of proper circumstances, and with the approval of the Maritime Commission, allow an extension or extensions of time, not to exceed two years in the aggregate, within which the contract shall be entered into and the deposits expended or obligated, or the 12½ per cent of the construction or contract price shall be paid or irrevocably committed.

A taxpayer requiring such extension shall make application therefor to the Commissioner of Internal Revenue, and transmit it with an appropriate statement of the circumstances, and appropriate documents in substantiation of the statement, to the Maritime Commission. The Commission will forward the application and accompanying documents to the Commissioner of Internal Revenue with a statement of its approval or disapproval. In case an application for extension is denied, the taxpayer will be liable for delay as though no application had been made.*

SEC. 32.20. *Period for construction.*—A new vessel constructed otherwise than under the provisions of Title V of the Act, and not purchased from the Maritime Commission must, within six months from the date of the construction contract, or within the period of any extension, be completed to the extent of not less than 5 per cent as estimated by the Maritime Commission and certified by it to the Secretary of the Treasury. In case of a contract covering more than one vessel it will be sufficient if one of the vessels is 5 per cent completed within the six months' period from the date of the contract or within the period of any extension, and so certified. All construction must be completed with reasonable dispatch as determined by the Maritime Commission. If, for causes within the control of the taxpayer, the entire construction is not completed with reasonable dispatch, the Commission will so certify to the Secretary of the Treasury. For the effect of such certification, see section 32.21.

The Commissioner of Internal Revenue may, upon application and a showing of satisfactory reasons therefor, grant an extension or extensions of time within which the 5 per cent of construction shall be completed, but such extensions shall not aggregate more than one year. In other words, no extension may be granted which shall allow a total period, for the required 5 per cent completion, of more than 18 months from the date of the construction contract. Extension will be granted only upon approval of the Maritime Commission. Application therefor shall be made in accordance with the

procedure indicated by section 32.19. In case an application for extension is denied, the taxpayer will be liable for delay as though no application had been made.*

SEC. 32.21. *Noncompliance with requirements.*—Withdrawal from the construction reserve fund for purposes other than the construction or acquisition of new vessels, or failure to comply with the requirements of the statute or the regulations relative to the utilization of such funds in the construction or acquisition of new vessels, will result in the recognition, for the taxable year in which realized, of the amount of the gain represented in that portion of the fund involved. If securities on deposit in a construction reserve fund are sold and the amount placed in the fund in lieu thereof is less than the market value of the securities at the time of their deposit, the difference between such market value and the amount placed in the fund in lieu of the securities will be deemed to have been withdrawn.

In the event of noncompliance with the prescribed conditions relative to any contract for construction or acquisition of new vessels, recognition will extend to the entire amount of the gain represented in that portion of the construction reserve fund obligated under such contract. Thus, if the Maritime Commission determines and certifies to the Secretary of the Treasury that for causes within the control of the taxpayer construction under a contract is not completed with reasonable dispatch, the entire amount of the gain represented in the portion of the construction reserve fund obligated under the contract will be recognized even though all other conditions have been satisfied. In case of noncompliance with the requirements of the statute or these regulations, see section 32.17 as to the allocation of gain.

Noncompliance with the provisions of the statute or these regulations relative to the utilization of the deposited amounts may also, inasmuch as the statutory presumption of subsection (f) is then inapplicable, warrant an examination to ascertain whether such amounts constitute an unreasonable accumulation of earnings and profits within the meaning of section 102 of the Internal Revenue Code. Under that section and the regulations thereunder, if such amounts are deposited and the fund maintained in good faith for the purpose of the construction or acquisition of new vessels, such amounts will not constitute an unreasonable accumulation.*

SEC. 32.22. *Extent of tax liability.*—Inclusion of gain in gross income shall be for all income and excess-profits tax purposes, but not for the purposes of the declared value excess-profits tax and the capital stock tax. In lieu of any adjustment with respect to the declared value excess-profits tax, there is imposed for the taxable year in which the gain was realized (see section 32.17) an additional tax of 1.1 per cent of the amount of the gain. No additional capital stock tax liability is incurred.

In the case of deposits in the construction reserve fund of amounts derived from sources other than those specified in the statute, or in the case of failure to deposit an amount equal to the "net proceeds" or "net indemnity" within the prescribed statutory period, the taxpayer obtains no suspension or postponement of any tax liability and the tax is collectible without regard to the provisions of the statute. (See section 32.13.)*

SEC. 32.23. *Assessment and collection of deficiencies.*—Any additional tax, including the 1.1 per cent of the amount of the gain imposed in lieu of declared value excess-profits tax, due on account of withdrawal from a construction reserve fund, or failure to comply with the provisions of the statute or the regulations, is collectible as a deficiency. Interest upon such deficiency will run from the date the withdrawal or noncompliance occurs. The amount of any deficiency, including interest and additions to the tax, determined as a result of such withdrawal or noncompliance, may be assessed, or a proceeding in court for the collection thereof may be begun without assessment, at any time and without regard to any period of limitations or any other provisions of law or rule of law, including the doctrine of res judicata.*

SEC. 32.24. *Reports by taxpayers.*—With each income tax return filed for a taxable year during any part of which a construction reserve fund is in existence the taxpayer shall submit a statement setting forth a detailed analysis of such fund. The statement, which need not be on any prescribed form, shall include the following information with respect to the construction reserve fund:

(1) The actual balance in the fund at the beginning and end of the taxable year;

(2) The date, amount, and source of each deposit during the taxable year;

(3) If item (2) consists of proceeds from the sale, or indemnificaton of loss, of a vessel, the amounts of the unrecognized gain;

(4) The date, amount, and purpose of each expenditure or withdrawal from the fund; and

(5) The date and amount of each contract, under which deposited funds are deemed to be obligated during the taxable year, for construction or acquisition of a new vessel and the identification of such vessel.

Taxpayers shall keep such records and make such additional reports as the Commissioner of Internal Revenue or the Maritime Commission may require.*

SEC. 32.25. *Construction or acquisition by controlled corporation.*—For the purposes of the statute and these regulations a new vessel is considered as constructed or acquired by the taxpayer if constructed or acquired by a corporation at a time when the taxpayer owns not less than 95 per cent of the total number of shares of each class of stock of the corporation.*

SEC. 32.26. *Basis of new vessel.*—The basis for determining gain or loss and for depreciation for the purpose of Federal income or excess-profits taxes with respect to a new vessel constructed or acquired by the taxpayer with funds deposited in the construction reserve fund, is reduced by the amount of the unrecognized gain represented in the funds allocated under the provisions of these regulations to the cost of such vessel. (See section 32.17.)*

SEC. 32.27. *Administrative jurisdiction.*—Sections 32.3 to 32.11, inclusive, and section 32.18 deal primarily with matters under the jurisdiction of the Maritime Commission. Sections 32.12, 32.16, and 32.17 and sections 32.21 to 32.26, inclusive, deal primarily with matters under the jurisdiction of the Commissioner of Internal Revenue. Generally, matters relating to the establishment, maintenance, expenditure, and use of construction reserve funds and the construction or acquisition of new vessels are under the jurisdiction of the Maritime Commission; and matters relating to the determination, assessment, and collection of taxes are under the jurisdiction of the Commissioner of Internal Revenue. Correspondence should be addressed to the particular authority having jurisdiction in the matter.*

GUY T. HELVERING,
Commissioner of Internal Revenue.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

By order of the United States Maritime Commission.

W. C. PEETS, Jr.,
Secretary.

JANUARY 31, 1941.

(Filed with the Division of the Federal Register January 31, 1941, 11.49 a. m.)

SECTION 3 OF THE VINSON ACT (48 STAT., 503, 505), AS AMENDED BY ACT OF JUNE 25, 1936 (49 STAT., 1926), AND BY ACT OF APRIL 3, 1939 (53 STAT., 555, 560).—ACT OF JUNE 28, 1940 (PUBLIC, NO. 671).—SECTION 401, SECOND REVENUE ACT OF 1940 (PUBLIC, NO. 801, SEVENTY-SIXTH CONGRESS, THIRD SESSION).

1941–5–10586
T. D. 5034

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 31.—EXCESS PROFITS ON CONTRACTS FOR NAVAL VESSELS AND ARMY AND NAVY AIRCRAFT.

Treasury Decisions 4906 [C. B. 1939–2, 404], 4909 [C. B. 1939–2, 422], and 5000 [C. B. 1940–2, 397] suspended with respect to certain contracts and subcontracts by reason of section 401 of the Second Revenue Act of 1940.

TREASURY DEPARTMENT,
OFFICE OF THE SECRETARY OF THE TREASURY,
Washington, D. C.

WAR DEPARTMENT,
OFFICE OF THE SECRETARY OF WAR,
Washington, D. C.

NAVY DEPARTMENT,
OFFICE OF THE SECRETARY OF THE NAVY,
Washington, D. C.

To Officers and Employees of the Treasury Department, the War Department, the Navy Department, and Others Concerned:

PARAGRAPH 1. Section 401 of the Second Revenue Act of 1940 (Public, No. 801, Seventy-sixth Congress, third session), approved October 8, 1940, provides:

SEC. 401. SUSPENSION OF PROFIT-LIMITING PROVISIONS OF THE VINSON ACT.

The provisions of section 3 of the Act of March 27, 1934 (48 Stat. 505; 34 U. S. C., section 496), as amended, beginning with the first proviso thereof, and section 2(b) of the Act of June 28, 1940 (Public, Numbered 671, Seventy-sixth Congress, third session), shall not apply to contracts or subcontracts for the construction or manufacture of any complete naval vessel or any Army or Navy aircraft, or any portion thereof, which are entered into in any taxable year in which the excess profits tax provided in Subchapter E of Chapter 2 of the Internal Revenue Code is applicable or would be applicable if the contractor or subcontractor, as the case may be, were a corporation, and any agreement to pay into the Treasury profit in excess of 10 per centum, 12 per centum, or 8 per centum, as the case may be, of the contract prices of any such contracts or subcontracts shall be without effect. This section shall also apply to such contracts or subcontracts which were entered into before the date of the beginning of the contractor's or subcontractor's first taxable year which begins in 1940 and which are not completed before such date.

PAR. 2. The excess profits tax provided in Subchapter E of Chapter 2 of the Internal Revenue Code, as added by section 201 of the Second Revenue Act of 1940, is applicable only with respect to taxable years beginning after December 31, 1939. Pursuant to the above-quoted section 401, the provisions of Treasury Decision 4906 [C. B. 1939–2, 404] [Part 17, Title 26, Code of Federal Regulations, 1939 Sup.], relating to excess profits on contracts for naval vessels and aircraft, Treasury Decision 4909 [C. B. 1939–2, 422] [Part 16,

Title 26, Code of Federal Regulations, 1939 Sup.], relating to excess profits on contracts for Army aircraft, and Treasury Decision 5000 [C. B. 1940–2, 397] [Part 26, Title 26, Code of Federal Regulations, 1940 Sup.], relating to excess profits on contracts for naval vessels and Army and Navy aircraft, shall not apply with respect to the following contracts and subcontracts otherwise coming within the scope of any of such Treasury decisions:

(1) Those which are entered into in any taxable year of the contractor or subcontractor (as the case may be) to which the excess profits tax is applicable, or to which such tax would be applicable if the contractor or subcontractor (as the case may be) were a corporation; and

(2) Those which are entered into before, but not completed before, the beginning of the contractor's or subcontractor's (as the case may be) first taxable year which begins in 1940.

Paragraph 2 may be illustrated by the following examples:

Example (1): On May 1, 1939, the X Corporation, which makes its income tax returns on the calendar year basis, entered into a contract which was (as of the date entered into) within the scope of Treasury Decision 4909, such contract being completed on November 1, 1940. Pursuant to such prime contract, the X Corporation, on June 1, 1939, entered into a subcontract with the Y Corporation, which makes its income tax returns on the basis of a fiscal year ending June 30. The subcontract, which was also (as of the date entered into) within the scope of Treasury Decision 4909, was completed on June 15, 1940. Since the prime contract was not completed before the beginning of the contractor's first taxable year which begins in 1940 (January 1, 1940), Treasury Decision 4909 does not apply with respect thereto. Since the subcontract was not entered into in a taxable year to which the excess profits tax applies and since it was completed before the beginning of the subcontractor's first taxable year which begins in 1940 (July 1, 1940), Treasury Decision 4909 continues to apply with respect thereto.

Example (2): On October 1, 1939, the X Corporation, which makes its income tax returns on the basis of a fiscal year ending August 31, entered into a contract which was (as of the date entered into) within the scope of Treasury Decision 4909, such contract being completed on July 29, 1940. Pursuant to such prime contract, the X Corporation, on December 23, 1939, entered into a subcontract with the Y Corporation, which makes its income tax returns on the calendar year basis. The subcontract, which was also (as of the date entered into) within the scope of Treasury Decision 4909, was completed on February 15, 1940. Since the prime contract was not entered into in a taxable year to which the excess profits tax applies and since it was completed before the beginning of the contractor's first taxable year which begins in 1940 (September 1, 1940), Treasury Decision 4909 continues to apply with respect thereto. Since the subcontract was not completed before the beginning of the subcontractor's first taxable year which begins in 1940 (January 1, 1940), Treasury Decision 4909 does not apply with respect thereto.

PAR. 3. The date of completion of a particular contract or subcontract shall, for the purposes of this Treasury decision, be determined in accordance with the provisions of Treasury Decision 4906, 4909, or

5000, whichever is applicable, or would have been applicable except for the provisions of section 401 of the Second Revenue Act of 1940 and this Treasury decision issued thereunder, to such contract or subcontract.

PAR. 4. An agreement contained in any of the contracts or subcontracts referred to in paragraph 2 of this Treasury decision, to pay into the Treasury profit in excess of 10, 12, or 8 per cent (as the case may be) of the contract price thereof, shall be without effect.

(This Treasury decision is issued under the authority contained in section 401 of the Second Revenue Act of 1940 (Public, No. 801, Seventy-sixth Congress, third session), sections 2(b), 3, and 4 of the Act of June 28, 1940 (Public, No. 671, Seventy-sixth Congress, third session), section 14 of the Act of April 3, 1939, 53 Stat., 560 (10 U. S. C., Sup., 311; 34 U. S. C., Sup., 496), and section 3 of the Act of March 27, 1934, 48 Stat., 505 (34 U. S. C., 496), as amended by the Act of June 25, 1936, 49 Stat., 1926 (34 U. S. C., Sup., 496), and as further amended and made applicable to contracts and subcontracts for Army aircraft by section 14 of such Act of April 3, 1939.)

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved December 3, 1940.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

Approved January 10, 1941.

HENRY L. STIMSON,
Secretary of War.

Approved January 24, 1941.

FRANK KNOX,
Secretary of the Navy.

(Filed with the Division of the Federal Register January 29, 1941, 11.50 a. m.)

OLEOMARGARINE.[a]

1941–1–10557
MS. 233

Schedule of oleomargarine produced and materials used during the month of November, 1940, as compared with November, 1939.

	November, 1940.	November, 1939.
	Pounds.	*Pounds.*
Total production of uncolored oleomargarine	[1] 29,724,028	[2] 27,743,186
Total withdrawn tax-paid	30,820,646	27,689,512
Ingredient schedule of uncolored oleomargarine:		
Babassu oil	55,550	1,057,357
Coconut oil	1,564,411	2,108,369
Corn oil	16,321	34,171
Cottonseed oil	10,889,014	9,683,122
Derivative of glycerine	66,323	71,858
Lecithin	10,413	7,097
Milk	5,494,772	5,307,196
Monostearine	18,529	
Neutral lard	400,690	115,957
Oleo oil	1,321,896	730,704
Oleo stearine	262,757	227,795
Oleo stock	102,899	84,130
Peanut oil	157,051	200,828
Salt	1,101,177	1,201,100
Soda (benzoate of)	10,692	10,503
Soya bean oil	9,186,556	8,039,038
Soya bean stearine	200	
Vitamin concentrate	1,086	1,690
Total	30,660,337	28,880,915
Total production of colored oleomargarine	[3] 278,001	[4] 142,724
Total withdrawn tax-paid	33,780	29,248
Ingredient schedule of colored oleomargarine:		
Butter flavor	2	
Coconut oil	99,846	45,243
Color	268	164
Corn oil	18	25
Cottonseed oil	19,282	17,602
Cottonseed stearine	60	855
Derivative of glycerine	324	354
Lecithin	81	55
Milk	49,828	29,503
Monostearine	397	
Neutral lard	5,126	3,752
Oleo oil	23,422	14,241
Oleo stearine	575	450
Oleo stock	3,800	1,310
Peanut oil	67	301
Salt	18,248	8,456
Soda (benzoate of)	98	47
Soya bean oil	70,638	35,037
Soya bean stearine	480	
Vitamin concentrate	2	3
Total	292,562	157,398

[a] Figures are subject to revision until published in the Commissioner's annual report.
[1] Of the amount produced, 16,546 pounds were reworked.
[2] Of the amount produced, 27,029 pounds were reworked.
[3] Of the amount produced, 2,528 pounds were reworked.
[4] Of the amount produced, 128 pounds were reworked.

1941–5–10582
MS. 234

Schedule of oleomargarine produced and materials used during the month of December, 1940, as compared with December, 1939.

	December, 1940.	December, 1939.
	Pounds.	*Pounds.*
Total production of uncolored oleomargarine	[1] 32,216,785	[2] 25,438,984
Total withdrawn tax-paid	31,080,270	25,711,698
Ingredient schedule of uncolored oleomargarine:		
Babassu oil	13,660	659,111
Coconut oil	1,452,234	1,912,842
Corn oil	33,763	53,493
Cottonseed oil	13,087,959	8,765,590
Derivative of glycerine	73,614	60,257
Lecithin	12,791	7,142
Milk	5,966,821	4,958,870
Monostearine	18,433	
Neutral lard	768,978	201,718
Lard stearine	240	
Oleo oil	1,450,385	860,384
Oleo stearine	300,743	236,008
Oleo stock	153,505	78,427
Peanut oil	181,318	193,650
Salt	1,232,445	1,050,755
Soda (benzoate of)	11,894	9,116
Soya bean oil	8,490,715	7,546,246
Vitamin concentrate	1,475	1,342
Total	33,250,973	26,594,951
Total production of colored oleomargarine	[3] 239,980	[4] 148,126
Total withdrawn tax-paid	38,080	25,499
Ingredient schedule of colored oleomargarine:		
Butter flavor	1	
Coconut oil	75,325	58,769
Color	182	115
Corn oil	23	54
Cottonseed oil	18,989	13,181
Cottonseed stearine	1,320	210
Derivative of glycerine	294	285
Lecithin	26	77
Milk	66,597	29,443
Monostearine	387	
Neutral lard	7,413	4,200
Oleo oil	26,258	15,526
Oleo stearine	296	
Oleo stock	2,350	956
Peanut oil	392	200
Salt	8,152	7,702
Soda (benzoate of)	73	35
Soya bean oil	58,900	29,108
Vitamin concentrate	3	1
Total	266,981	159,862

[1] Of the amount produced, 24,273 pounds were reworked.
[2] Of the amount produced, 10,425 pounds were reworked.
[3] Of the amount produced, 640 pounds were reworked.
[4] Of the amount produced, 1,475 pounds were reworked.

1941–9–10623
MS. 235

Schedule of oleomargarine produced and materials used during the month of January, 1941, as compared with January, 1940.

	January, 1941.	January, 1940.
	Pounds.	*Pounds.*
Total production of uncolored oleomargarine	[1] 33,617,656	[2] 29,204,468
Total withdrawn tax-paid	33,779,237	29,379,265
Ingredient schedule of uncolored oleomargarine:		
Babassu oil		692,201
Butter		64
Coconut oil	1,212,290	2,001,649
Corn oil	37,115	83,545
Cottonseed oil	13,415,083	10,055,129
Derivative of glycerine	86,230	72,406
Lecithin	76,858	7,165
Milk	6,155,518	5,666,278
Monostearine	15,796	
Neutral lard	770,157	238,029
Oleo oil	1,759,069	1,131,517
Oleo stearine	227,043	261,934
Oleo stock	153,677	119,617
Peanut oil	199,654	165,727
Salt	1,158,640	1,206,030
Soda (benzoate of)	13,359	11,639
Soya bean oil	9,272,395	8,939,392
Vegetable gum	2	
Vitamin concentrate	1,513	1,481
Total	34,554,399	30,653,803
Total production of colored oleomargarine	[b] [3] 412,204	[4] 149,578
Total withdrawn tax-paid	56,110	30,011
Ingredient schedule of colored oleomargarine:		
Butter flavor	2	
Coconut oil	68,092	49,779
Color	258	106
Corn oil	23	261
Cottonseed oil	35,335	21,968
Cottonseed stearine	300	60
Derivative of glycerine	391	316
Lecithin	352	83
Milk	71,266	29,591
Monostearine	354	
Neutral lard	6,414	2,871
Oleo oil	29,387	12,690
Oleo stearine	195	2,687
Oleo stock	4,163	661
Peanut oil	81	138
Salt	15,558	7,564
Soda (benzoate of)	145	36
Soya bean oil	187,921	33,837
Soya bean stearine	240	
Vitamin concentrate	2	3
Total	[5] 420,479	162,651

[b] These figures include manufacturers' returns which were not available for publication in prior reports.
[1] Of the amount produced, 18,792 pounds were reworked.
[2] Of the amount produced, 20,735 pounds were reworked.
[3] Of the amount produced, 224 pounds were reworked.
[4] Of the amount produced, 640 pounds were reworked.

1941-15-10671
MS. 237

Amended schedule of oleomargarine produced and materials used during the month of January, 1941, as compared with January, 1940.

	January, 1941.	January, 1940.
	Pounds.	*Pounds.*
Total production of uncolored oleomargarine	[1] 33,617,656	[2] 29,209,438
Total withdrawn tax-paid	33,779,237	29,378,643
Ingredient schedule of uncolored oleomargarine:		
Babassu oil		692,201
Butter		64
Coconut oil	1,212,290	2,001,649
Corn oil	37,115	83,545
Cottonseed oil	13,476,923	10,055,129
Derivative of glycerine	86,230	72,406
Lecithin	15,018	7,165
Milk	6,155,518	5,666,278
Monostearine	15,796	
Neutral lard	770,157	238,029
Oleo oil	1,759,069	1,131,517
Oleo stearine	227,043	261,934
Oleo stock	153,677	119,617
Peanut oil	199,654	165,727
Salt	1,158,640	1,206,030
Soda (benzoate of)	13,359	11,639
Soya bean oil	9,272,395	8,939,392
Vegetable gum	2	
Vitamin concentrate	1,513	1,481
Total	34,554,399	30,653,803
Total production of colored oleomargarine	[3] 412,204	[4] 149,582
Total withdrawn tax-paid	56,110	28,665
Ingredient schedule of colored oleomargarine:		
Butter flavor	2	
Coconut oil	68,092	49,779
Color	258	106
Corn oil	23	261
Cottonseed oil	35,335	21,968
Cottonseed stearine	300	60
Derivative of glycerine	391	316
Lecithin	352	83
Milk	71,266	29,591
Monostearine	354	
Neutral lard	6,414	2,871
Oleo oil	29,387	12,690
Oleo stearine	195	2,687
Oleo stock	4,163	661
Peanut oil	81	138
Salt	15,558	7,564
Soda (benzoate of)	145	36
Soya bean oil	187,921	33,837
Soya bean stearine	240	
Vitamin concentrate	2	3
Total	420,479	162,651

[1] Of the amount produced, 18,792 pounds were reworked.
[2] Of the amount produced, 20,735 pounds were reworked.
[3] Of the amount produced, 224 pounds were reworked.
[4] Of the amount produced, 640 pounds were reworked.

1941–14–10668
MS. 236

Schedule of oleomargarine produced and materials used during the month of February, 1941, as compared with February, 1940.

	February, 1941.	February, 1940.
	Pounds.	*Pounds.*
Total production of uncolored oleomargarine	[1] 27,765,301	[2] 29,313,290
Total withdrawn tax-paid	27,829,055	28,446,041
Ingredient schedule of uncolored oleomargarine:		
Babassu oil	62,000	769,597
Butter		64
Coconut oil	1,178,909	1,785,788
Corn oil	39,148	88,514
Cottonseed oil	11,583,677	10,187,859
Derivative of glycerine	63,164	79,062
Lecithin	14,028	8,045
Milk	5,285,949	5,723,102
Monostearine	10,961	
Neutral lard	497,115	330,750
Oleo oil	1,137,272	1,311,582
Oleo stearine	252,601	259,362
Oleo stock	117,445	103,092
Peanut oil	162,858	152,830
Salt	986,022	1,221,719
Soda (benzoate of)	10,421	10,323
Soya bean oil	7,318,594	8,611,384
Soya flakes	15	
Vegetable gum		583
Vitamin concentrate	1,295	1,701
Total	28,721,474	30,645,357
Total production of colored oleomargarine	[3] 337,416	[4] 168,789
Total withdrawn tax-paid	39,484	29,773
Ingredient schedule of colored oleomargarine:		
Butter flavor	2	
Coconut oil	116,988	55,328
Color	386	147
Corn oil	39	54
Cottonseed oil	41,823	12,503
Cottonseed stearine	2,340	360
Derivative of glycerine	392	640
Lecithin	46	78
Milk	62,226	38,145
Monostearine	399	
Neutral lard	6,322	2,176
Oleo oil	23,742	25,664
Oleo stearine	355	1,475
Oleo stock	2,550	2,362
Peanut oil	177	13
Salt	12,442	10,008
Soda (benzoate of)	150	39
Soya bean oil	74,926	46,098
Soya bean stearine	240	
Vitamin concentrate	3	2
Total	345,548	195,092

[1] Of the amount produced, 23,016 pounds were reworked.
[2] Of the amount produced, 21,741 pounds were reworked.
[3] Of the amount produced, 379 pounds were reworked.
[4] Of the amount produced, 30 pounds were reworked.

1941–17–10697
MS. 238

Schedule of oleomargarine produced and materials used during the month of March, 1941, as compared with March, 1940.

	March, 1941.	March, 1940.
	Pounds.	*Pounds.*
Total production of uncolored oleomargarine	[1] 33,588,531	[2] 26,523,191
Total withdrawn tax-paid	34,288,031	26,800,262
Ingredient schedule of uncolored oleomargarine:		
Babassu oil	66,280	525,197
Butter		60
Coconut oil	1,308,270	2,421,474
Corn oil	39,352	86,219
Cottonseed oil	13,120,097	9,013,808
Derivative of glycerine	85,068	62,607
Lecithin	15,655	7,554
Milk	6,359,036	5,045,721
Monostearine	15,081	
Neutral lard	893,661	297,738
Oleo oil	1,533,341	1,302,816
Oleo stearine	281,314	242,077
Oleo stock	130,010	94,095
Palm oil		1,050
Peanut oil	164,876	146,144
Salt	1,176,750	1,076,929
Soda (benzoate of)	14,710	10,100
Soya bean oil	9,396,443	7,125,375
Vegetable gum		1,179
Vitamin concentrate	1,586	1,287
Total	34,601,530	27,461,430
Total production of colored oleomargarine	291,467	137,958
Total withdrawn tax-paid	40,397	29,269
Ingredient schedule of colored oleomargarine:		
Babassu oil		498
Butter flavor	1	
Coconut oil	115,498	42,930
Color	247	110
Corn oil	34	62
Cottonseed oil	21,420	7,495
Cottonseed stearine	1,230	270
Derivative of glycerine	215	282
Lecithin	57	54
Milk	54,692	28,649
Monostearine	273	
Neutral lard	5,164	2,965
Oleo oil	27,264	14,396
Oleo stearine	655	400
Oleo stock	3,200	1,810
Palm oil	750	
Peanut oil	243	11
Salt	10,887	6,692
Soda (benzoate of)	81	40
Soya bean oil	59,667	43,804
Vitamin concentrate	2	2
Total	301,580	150,440

[1] Of the amount produced, 32,317 pounds were reworked.
[2] Of the amount produced, 16,706 pounds were reworked.

1941–23–10739
MS. 239

Schedule of oleomargarine produced and materials used during the month of April, 1941, as compared with April, 1940.

	April, 1941.	April, 1940.
	Pounds.	*Pounds.*
Total production of uncolored oleomargarine	[1] 31, 766, 461	[2] 27, 233, 829
Total withdrawn tax-paid	30, 534, 999	27, 551, 584
Ingredient schedule of uncolored oleomargarine:		
Babassu oil	211, 130	935, 954
Coconut oil	1, 210, 234	3, 016, 302
Corn oil	37, 612	32, 364
Cottonseed oil	12, 862, 627	8, 173, 118
Derivative of glycerine	78. 023	77, 947
Lecithin	15, 008	6, 948
Milk	5, 941, 639	5, 208, 285
Monostearine	13, 695	
Neutral lard	879, 583	633, 964
Oleo oil	1, 375, 165	1, 216, 693
Oleo stearine	361, 155	312, 881
Oleo stock	81, 518	117, 440
Palm oil	13, 600	
Peanut oil	158, 572	112, 514
Salt	1, 103, 855	1, 129, 257
Soda (benzoate of)	12, 648	9, 615
Soya bean oil	8, 350, 760	7, 103, 705
Soya bean stearine		500
Vitamin concentrate	1, 534	1, 294
Total	[3] 32, 708, 358	28, 088, 781
Total production of colored oleomargarine	[4] 412, 779	[5] 177, 346
Total withdrawn tax-paid	44, 313	29, 955
Ingredient schedule of colored oleomargarine:		
Babassu oil		831
Butter flavor	6	
Coconut oil	171, 179	68, 050
Color	304	120
Corn oil	6	3
Cottonseed oil	33, 836	14, 881
Cottonseed stearine	900	
Derivative of glycerine	671	403
Lecithin	38	86
Milk	74, 623	36, 212
Monostearine	306	
Neutral lard	5, 764	3, 958
Oleo oil	26, 780	18, 275
Oleo stearine		820
Oleo stock	2, 275	2, 120
Palm oil	17, 770	
Peanut oil	62	38
Salt	14, 243	8, 032
Soda (benzoate of)	211	73
Soya bean oil	71, 663	36, 785
Soya bean stearine	471	
Vitamin concentrate	1	3
Total	421, 109	190, 690

[1] Of the amount produced, 42,567 pounds were reworked.
[2] Of the amount produced, 24,432 pounds were reworked.
[3] Includes manufacturers' returns which were not available for publication in prior schedule.
[4] Of the amount produced, 348 pounds were reworked.
[5] Of the amount produced, 12 pounds were reworked.

1941–26–10761
MS. 240

Schedule of oleomargarine produced and materials used during the month of May, 1941, as compared with May, 1940.

	May, 1941.	May, 1940.
	Pounds.	*Pounds.*
Total production of uncolored oleomargarine	[1] 26,304,376	[2] 24,522,727
Total withdrawn tax-paid	26,804,840	24,122,195
Ingredient schedule of uncolored oleomargarine:		
Babassu oil		961,032
Coconut oil	1,117,395	2,466,628
Corn oil	39,287	48,124
Cottonseed oil	11,169,921	8,450,271
Derivative of glycerine	61,865	66,409
Diacetyl	1	
Emulsol	10	
Lecithin	13,927	6,828
Milk	4,860,157	4,656,147
Monostearine	11,964	
Neutral lard	593,191	493,522
Oleo oil	1,240,696	919,428
Oleo stearine	256,250	309,575
Oleo stearine oil		88,000
Oleo stock	76,488	89,614
Palm oil	477	488
Peanut oil	166,403	132,820
Salt	909,382	981,249
Soda (benzoate of)	11,091	10,200
Soya bean oil	6,645,189	5,683,591
Soya bean stearine	295	1,100
Vitamin concentrate	1,129	1,203
Total	27,175,118	25,366,229
Total production of colored oleomargarine	1,388,414	[3] 180,537
Total withdrawn tax-paid	47,830	28,171
Ingredient schedule of colored oleomargarine:		
Babassu oil		1,016
Butter flavor	4	
Coconut oil	351,084	60,124
Color	1,371	123
Corn oil	52	1
Cottonseed oil	273,840	17,487
Cottonseed stearine	5,520	360
Derivative of glycerine	3,024	425
Lecithin	528	73
Milk	241,321	34,761
Monostearine	887	
Neutral lard	41,866	3,747
Oleo oil	198,682	13,590
Oleo stearine	410	625
Oleo stock	1,844	1,449
Palm oil	7,270	
Peanut oil	129	24
Salt	47,263	7,564
Soda (benzoate of)	556	63
Soya bean oil	253,133	43,533
Soya bean stearine	238	
Vitamin concentrate	5	2
Total	1,429,027	184,967

[1] Of the amount produced, 19,811 pounds were reworked.
[2] Of the amount produced, 29,744 pounds were reworked.
[3] Of the amount produced, 416 pounds were reworked.

TOBACCO.[a]

1941–5–10585
T. 79

Statement of manufactured tobacco produced, by classes, during the month of November, 1940, as compared with November, 1939.

	November, 1940.	November, 1939.
	Pounds.	*Pounds.*
Plug	3,941,841	3,851,324
Twist	442,340	515,243
Fine-cut chewing	421,429	365,549
Scrap chewing	3,256,260	3,415,282
Smoking	17,641,733	17,466,579
Total	25,703,603	25,613,977

1941–9–10622
T. 80

Statement of manufactured tobacco produced, by classes, during the month of December, 1940, as compared with December, 1939.

	December, 1940.	December, 1939.
	Pounds.	*Pounds.*
Plug	3,681,357	3,763,223
Twist	456,316	448,759
Fine-cut chewing	380,070	323,309
Scrap chewing	3,196,397	3,195,678
Smoking	15,227,235	14,420,982
Total	22,941,375	22,151,951

1941–14–10669
T. 81

Statement of manufactured tobacco produced, by classes, during the month of January, 1941, as compared with January, 1940.

	January, 1941.	January, 1940.
	Pounds.	*Pounds.*
Plug	3,881,717	3,484,165
Twist	457,002	399,495
Fine-cut chewing	426,459	330,480
Scrap chewing	3,635,698	3,590,964
Smoking	16,751,661	15,165,040
Total	25,152,537	22,970,144

[a] Figures are subject to revision until published in the Commissioner's annual report.

1941–18–10701
T. 82

Statement of manufactured tobacco produced, by classes, during the month of February, 1941, as compared with February, 1940.

	February, 1941.	February, 1940.
	Pounds.	*Pounds.*
Plug	3,748,168	4,035,409
Twist	461,274	481,224
Fine-cut chewing	355,257	299,909
Scrap chewing	3,347,215	3,396,970
Smoking	14,718,571	15,835,734
Total	22,630,485	24,049,246

1941–22–10728
T. 83

Statement of manufactured tobacco produced, by classes, during the month of March, 1941, as compared with March, 1940.

	March, 1941.	March, 1940.
	Pounds.	*Pounds.*
Plug	4,065,325	3,805,804
Twist	467,691	453,734
Fine-cut chewing	389,360	335,070
Scrap chewing	3,385,380	3,363,062
Smoking	16,458,306	16,086,939
Total	24,766,062	24,044,609

BOARD OF TAX APPEALS.

1941–16–10683

RULES OF PRACTICE BEFORE THE UNITED STATES BOARD OF TAX APPEALS.

INTRODUCTION.

These revised rules are promulgated pursuant to authority of section 1111, Internal Revenue Code, which provides that "The proceedings of the Board and its divisions shall be conducted in accordance with such rules of practice and procedure (other than rules of evidence) as the Board may prescribe and in accordance with the rules of evidence applicable in the courts of the District of Columbia in the type of proceedings which prior to September 16, 1938, were within the jurisdiction of the courts of equity of said District."

Congress in the Revenue Acts has enacted provisions relating to the organization, jurisdiction, and procedure of the Board of Tax Appeals, and to the action of the Bureau of Internal Revenue with respect to the assessment and collection of deficiencies when a petition has been filed with the Board. Reference is made to those statutory provisions in the Revenue Acts for procedural requirements other than those relating to the conduct of proceedings before the Board and its divisions to which these rules of practice are limited. Attention is called to the Internal Revenue Code for convenient reference, and particularly to sections 271, 272, 273, 1100, and 1142.

RULE 1. BUSINESS HOURS.

The office of the Board at Washington, D. C., will be open each business day from 9 o'clock a. m. to 4.30 o'clock p. m.

RULE 2. ADMISSION TO PRACTICE.

Persons of the following classes who are found by the Board, upon consideration of their applications, to be citizens of the United States, of good moral character, and to possess the requisite qualifications to represent others, may be admitted to practice before the Board:

(*a*) Attorneys at law who are admitted to practice before the Supreme Court of the United States or the highest court of any State or Territory or of the District of Columbia.

(*b*) Certified public accountants duly qualified under the laws of any State or Territory or of the District of Columbia.

Corporations and firms will not be admitted or recognized.

An applicant for admission must file his application with the Board on the form provided. Forms will be furnished upon request to the secretary of the Board. Such application shall be accompanied by a current certificate of the clerk of the court in which the applicant is admitted to practice to the effect that he has been so admitted and is in good standing; or a current certificate by the proper State, Territorial, or District authority to the effect that the applicant is a certified public accountant in good standing, duly qualified and entitled to practice in such State or Territory or the District of Columbia.

The Board may deny admission to, suspend, or disbar any person who in its judgment does not possess the requisite qualifications to represent others, or who is lacking in character, integrity, or proper professional conduct. No person shall be suspended for more than 60 days or disbarred until he has been afforded an opportunity to be heard. A division may immediately suspend any person for not more than 60 days for contempt or misconduct during the course of any proceeding.

The Board may require any practitioner before it to furnish a statement under oath of the terms and circumstances of his employment in any proceeding.

RULE 3. PERSONAL REPRESENTATION IN LIEU OF COUNSEL.

Any individual taxpayer or member of a taxpayer partnership may appear for himself or such partnership upon adequate identification to the Board. A taxpayer corporation may be represented by a bona fide officer of the corporation upon permission granted, in its discretion, by the Board or the division sitting.

Rule 4. Form and Style of Papers.

All papers filed with the Board shall be either printed or typewritten, and if typewritten, shall be on only one side of plain white paper. This paper shall be not more than 8½ inches wide and 11 inches long, and shall weigh not less than 16 pounds to the ream. The papers shall be fastened on the left side and at no other place.

Typewritten papers shall have no covers or backs. Copies shall be clear and legible but may be on any weight paper. If printed, they shall be in 10 or 12 point type, on good unglazed paper, 5⅞ inches wide by 9 inches long, with inside margin not less than 1 inch wide, and with double-leaded text and single-leaded quotations. Citations shall be in italics when printed, and underscored when typewritten.

The proper caption shall be placed upon all papers filed. If the petitioner is an individual, the full given name and surname shall be set forth in the caption. If the petitioner is a married woman, her given name shall be used, not the name of her husband preceded by "Mrs." If the petitioner is a fiduciary, the name of the estate, trust, or other person for whom he acts, shall be given first, followed by the name of the fiduciary. (See rules 5 and 6(*a*), and Appendix I, Form No. 2.)

Except as otherwise provided in these rules, a signed original and four conformed copies of all papers shall be filed. Whenever any paper is filed in more than one proceeding (as a motion to consolidate proceedings or in proceedings already consolidated), one additional copy shall be filed for each additional proceeding.

The written signature, whether of counsel or of the petitioner, shall be in individual and not in firm name, except that where the petitioner is a corporation the written signature shall be by an active officer of the corporation. The name and mailing address of the petitioner or of counsel shall be typed or printed immediately following the written signature.

Rule 5. Proper Parties.

The proceeding shall be brought by and in the name of the person against whom the Commissioner determined the deficiency [or liability, as the case may be], or by and in the full descriptive name of the fiduciary legally entitled to institute a proceeding on behalf of such person.

In the event of a variance between the name set forth in the notice of deficiency or liability and the correct name, a statement of the reasons for such variance shall be set forth in the petition. (See rules 4, 6, and 23.)

Rule 6. Initiation of a Proceeding—Petition.

A proceeding shall be initiated by filing with the Board a petition, as provided in rules 4, 5, and 8, and substantially in accordance with Form 2, shown in Appendix I. The petition shall be complete in itself so as fully to state the issues. It shall contain:

(*a*) A caption in the following form:

UNITED STATES BOARD OF TAX APPEALS.

----------, *petitioner*,
v.
Commissioner of Internal Revenue, respondent. } Docket No.

PETITION.

(*b*) Proper allegations showing jurisdiction in the Board.

(*c*) A statement of the amount of the deficiency [or liability, as the case may be], determined by the Commissioner, the nature of the tax, the period for which determined, the amount thereof (as nearly as may be computed) in controversy, and the collection district in which the return was filed.

(*d*) Clear and concise assignments of each and every error which the petitioner alleges to have been committed by the Commissioner in the determination of the deficiency. Issues in respect of which the burden of proof is by statute placed upon the Commissioner will not be deemed to be raised by the petitioner in the absence of assignments of error in respect thereof. Each assignment of error shall be numbered.

(*e*) Clear and concise numbered statements of the facts upon which the petitioner relies as sustaining the assignments of error, except those assignments of error in respect of which the burden of proof is by statute placed upon the Commissioner.

(*f*) A prayer, setting forth relief sought by the petitioner.

(*g*) The signature of the petitioner or that of his counsel. (See rule 4.)

(*h*) A verification by the petitioner; provided that where the petitioner is sojourning outside the United States or is a nonresident alien, the petition may be verified by a duly appointed attorney in fact, who shall attach to the petition a copy of the power of attorney under which he acts and who shall state in his verification that he acts pursuant to such power, that such power has not been revoked; that petitioner is absent from the United States, and the grounds of his knowledge of the facts alleged in the petition. As used herein the term "United States" includes only the States and the District of Columbia. A notary public is not authorized to administer oaths, etc., in matters in which he is employed as counsel. (See Title 4, ch. 2, D. C. Code, and 26 Op. A. G., 236.)

The verification shall contain a statement that the fiduciaries signing and verifying have authority to act for the taxpayer.

Where the petitioner is a corporation, the person verifying shall state in his verification that he has authority to act for the corporation.

The signature and the verification to the petition shall be considered the certificate of those performing these acts that there is good ground for the petition, the proceeding has not been instituted merely for delay, and it is not frivolous.

(*i*) A copy of the notice of deficiency [or liability, as the case may be], shall be appended to the petition. If a statement has accompanied the notice of deficiency, so much thereof as is material to the issues set out in the assignments of error likewise shall be appended. If the notice of deficiency refers to prior notices from the Bureau, which are necessary to elucidate the determination, such parts thereof as are material to the issues set out in the assignments of error shall likewise be appended. (See Appendix I, Form No. 2.)

Rule 7. Filing of Petition.

An original and four clear copies of the petition, either printed or typewritten as provided by rule 4, shall be filed with the Board. (See rule 9.) The copies of the petition shall be conformed to the original by the petitioner.

Failure to file a sufficient number of copies, as provided in this rule, or to conform to the requirements of rules 4, 5, and 8, shall be ground for the dismissal of the proceeding.

Rule 8. Fee for Filing Petition.

The fee for filing a petition with the Board shall be $10, payable at the time of filing.

Rule 9. Filing.

Any document to be filed with the Board, must be filed at the office of the Board in Washington, D. C., during business hours; provided, that a division hearing a proceeding may permit documents pertaining thereto to be filed at the hearing.

Rule 11. Docket.

Upon receipt of the petition, the proceeding will be docketed and assigned a number and the parties notified thereof. This number shall be placed by the parties on all papers thereafter filed in the proceeding.

Rule 12. Service of the Petition.

Upon filing of a petition and the copies, as prescribed in rule 7, the clerk will serve a copy upon the Commissioner.

Rule 14. Answer.

After service upon him of a copy of the petition, the Commissioner shall have 60 days within which to file an answer or 45 days within which to move in respect of the petition. The answer shall be so drawn as fully and completely to advise the petitioner and the Board of the nature of the defense. It shall contain a specific admission or denial of each material allegation of fact contained

in the petition and a statement of any facts upon which the Commissioner relies for defense or for affirmative relief or to sustain any issue raised in the petition in respect of which issue the burden of proof is, by statute, placed upon the Commissioner. Each paragraph contained in the answer shall be numbered to correspond with the paragraphs of the petition. An original and four copies of the answer shall be filed, of which the original shall be signed by the Commissioner or his counsel and the copies conformed by him.

The clerk will serve one copy of the answer upon the petitioner or his counsel of record by registered mail.

Rule 15. Reply.

If the answer of the Commissioner sets forth facts upon which he relies for affirmative relief, or contains a statement of the facts upon which he relies to sustain an issue in respect of which the burden of proof is placed upon him by statute, the petitioner shall, within 45 days after a copy of such answer is mailed to him or his counsel of record by registered mail, file a reply which shall contain a specific admission or denial of each material allegation of fact contained in the answer and shall set forth any facts upon which he relies for defense. Each paragraph contained in the reply shall be numbered to correspond with the paragraphs of the answer. An original and four copies of the reply shall be filed, of which the original shall be signed by the petitioner or his counsel and the copies conformed by him.

The Board upon motion of the respondent in which good cause is shown, or upon its own motion, may require the verification of any reply.

The clerk will serve one copy of the reply upon the Commissioner.

Rule 16. Joinder of Issue.

A proceeding shall be deemed at issue upon the filing of the answer unless a reply is required under rule 15, in which event the proceeding shall be deemed at issue upon the filing of the reply.

Rule 17. Amended and Supplemental Pleadings.

The petitioner may, as of course, amend his petition at any time before answer is filed. After answer is filed, a petition may be amended only by consent of the Commissioner or on leave of the Board.

All motions to amend, made prior to the hearing, must be accompanied by the proposed amendments or amended pleading.

Upon motion made, the Board may, in its discretion, at any time before the conclusion of the hearing, permit a party to a proceeding to amend the pleadings to conform to the proof.

When motions to amend are granted at the hearing, the amendment or amended pleading shall be filed at the hearing or with the Board within such time as the division may fix.

See rules 4 and 19.

Rule 18. Pleadings—General.

The Board, upon motion of either party in which good cause is shown, or upon its own motion, may order a further and better statement of the nature of the claim or defense, or of any matter stated in any pleading. Such a motion filed by a party shall point out the defects complained of and the details desired. If such order of the Board is not obeyed within 15 days or within such other time as the Board may fix, the Board may strike the pleading to which the motion was directed or may make such other order as it deems just.

If no reply is required by these rules, each and every material allegation of fact set out in the answer shall be deemed to be denied. Any new or affirmative matter contained in the reply shall be deemed to be denied.

Where an answer has been filed, each and every material allegation of fact set out in the petition and not expressly admitted or denied in the answer, shall be deemed to be admitted. Where a reply is required by these rules and a reply has been filed, each and every material allegation of fact set out in the answer and not expressly admitted or denied in the reply shall be deemed to be admitted.

Where no answer is filed or where a reply is required by these rules, but no reply is filed, the adverse party, within 45 days after the expiration of the time fixed by these rules for filing the answer or the reply, as the case may be (or within 45 days after the promulgation of these rules, whichever shall allow the

greater time), may file a motion with the Board calling attention to the fact that the pleading has not been filed within the specified time and certain material allegations of fact have not been denied, and requesting the Board to enter its order that those particular undenied allegations shall be deemed to be admitted. The Board will serve a copy of this motion upon the other party and issue an order to show cause, returnable on or before a day certain. If the above described motion is not filed within the prescribed time, the allegations of the pleading to which there was no response shall be deemed to be denied.

RULE 19. MOTIONS.

Motions must be timely. If a motion, other than one relating to the receipt of evidence during trial, is made orally during trial, the maker thereof shall promptly reduce it to writing and file it with the Board unless the division directs otherwise. Motions shall be prepared in the form and style prescribed by rule 4. The clerk will serve a copy of each motion upon the opposite party. Motions will be acted upon as justice may require and may, in the discretion of the Board, be placed upon the calendar for argument. (See also rule 30(*b*).) The filing of a motion shall not constitute cause for postponement of a hearing from the date set.

No motion for rehearing, further hearing, reconsideration or the like may, except by special leave of the Board, be filed more than 30 days after the opinion has been served; and no motion for vacation or revision of a decision may, except by special leave of the Board, be filed more than 30 days after the decision has been entered.

RULE 20. EXTENSIONS OF TIME.

Continuances, extensions of time (except for the filing of the petition and except as otherwise provided in these rules), and adjournments may be ordered by the Board on its own motion or may be granted by it in its discretion on motion of either party filed in writing and showing good and sufficent cause therefor.

RULE 21. DISMISSAL.

A proceeding may be dismissed for cause upon motion of either party or of the Board.

RULE 22. SERVICE.

When at any time there are two or more counsel of record for a petitioner, service will be made upon the one whose appearance was first entered of record, unless he has otherwise requested by writing filed with the Board, in which event service will be upon such other counsel of record as may be designated by him. However, service upon any counsel of record shall be deemed service upon the party. If there is no counsel of record, service will be made upon the petitioner.

Service may be made upon the Commissioner in person, upon deputies designated by him for the purpose of accepting service, or upon counsel appearing for the respondent in the proceeding. (See rules 12, 14, and 15.)

RULE 23. SUBSTITUTION OF PARTIES.

In the event of the death of a petitioner or for other cause, the Board may order the substitution of the proper parties. In the event of mistake in the name or title of a proper party, the Board may order substitution of the proper name or title. (See rule 5.)

Motions for substitution should be accompanied by a proper certificate of the court or official having custody of the record showing the interest of the party substituted. In the event of a change in the name of a corporation or other party petitioner, a motion to amend the pleadings to show such change should be filed, accompanied by a copy of the certificate, decree, or other document, effecting such change, certified by the official having custody of such document, unless the parties have agreed to the change and have so indicated in the record.

RULE 24. SUBSTITUTION OR WITHDRAWAL OF COUNSEL—NOTICE OF APPEARANCE.

Counsel of record in any proceeding desiring to withdraw must give prompt notice of his withdrawal to the Board and to his client. The Board may, in its discretion, withhold permission to counsel of record to withdraw.

Where the petition is not subscribed by counsel, or counsel of record has withdrawn, counsel subsequently appearing for the petitioner shall immediately file a notice of appearance, which shall include statements of his admission to practice before the Board and of his mailing address.

Notice of a change in the mailing address of counsel or petitioner shall be filed promptly with the Board, and a separate notice shall be filed for each docket number involved.

Rule 25. Calendars.

(*a*) *Washington and circuit calendars.*—Each proceeding when at issue will be placed either upon the Washington calendar or upon a circuit calendar, in accordance with rule 26. (See Appendix II.)

(*b*) *Hearing calendars.*—The clerk, as directed from time to time by the chairman, will prepare hearing calendars.

(*c*) *Reserve calendar.*—A proceeding which is at issue may be placed upon the reserve calendar for good cause shown, as, for example, to await the decision of the Supreme Court in a pending case.

Rule 26. Place of Hearing—Requests and Designation.

The petitioner at the time of filing the petition shall also file a request showing the name of the place where he would prefer the hearing on the merits to be held. A copy of this request will be served upon the Commissioner by the clerk of the Board.

If the petitioner has filed no request, or if the respondent desires that the hearing on the merits be held at some place other than the place requested by the petitioner, the respondent shall file at the time he files his answer, a request showing the name of the place preferred by him. A copy will be served upon the petitioner by the clerk of the Board.

These requests shall not be bound as a part of the petition or answer but shall be separate therefrom and shall consist of an original and four copies.

The Board will determine the place of hearing, with due regard to any request properly filed in the proceeding and in accordance with the statutory provision that the time and place of trial shall be fixed "with as little inconvenience and expense to taxpayers as is practicable," and, in all cases, will notify the parties of the place at which or in the vicinity of which the hearing on the merits will be held.

Motions for change in designation of the place of hearing, made after the notice of the time of the hearing has been mailed, will not be deemed to have been timely filed.

In case it is necessary for the Board to hear the parties on matters other than the merits, such hearing will be held in Washington unless good cause is shown for holding it elsewhere.

(See Appendix II for further information to assist in making requests as to place of hearing.)

Rule 27. Notice of Hearing.

When a proceeding has been placed upon the hearing calendar the clerk will, not less than 15 days in advance, notify the parties of the place where and the date when it will be called.

Rule 28. Call of Calendar and Assignment for Hearing.

The hearing calendar of proceedings to be heard at Washington will be called at 9.30 a. m. The hearing calendar of proceedings to be heard elsewhere will be called at the time indicated in the notice of hearing. Proceedings will be assigned therefrom for hearing in due course.

Rule 29. Failure To Appear.

The unexcused absence of a party or his counsel on the day set for the hearing of any proceeding will not be the occasion for delay. The hearing will proceed and the case will be regarded as submitted on the part of the absent party or parties.

The Board may require appearance for argument or it may accept briefs in lieu of personal appearance.

RULE 30. SUBMISSION WITHOUT HEARING OR APPEARANCE.

(*a*) *Submission of cases without hearing where facts are uncontested.*—Any proceeding not requiring a hearing for the submission of evidence (as, for example, where sufficient facts have been admitted, stipulated, or included in the record in some other way), may be submitted at any time by notice of the parties filed with the Board. The parties need not wait for the proceeding to be calendared and need not appear in person. The chairman will then assign the proceeding to a division for report, which division, upon request of the parties, will fix a time for filing briefs or for oral argument.

(*b*) A contested motion, not predicated upon an issue of fact, may be submitted in the same way.

See, however, rule 31.

RULE 31. EVIDENCE AND THE SUBMISSION OF EVIDENCE.

(*a*) *Rules applicable.*—The proceedings of the Board and its divisions will be conducted in accordance with the rules of evidence applicable in the courts of the District of Columbia in the type of proceedings which prior to September 16, 1938, were within the jurisdiction of the courts of equity of said District.

(*b*) *Stipulations.*—The parties, by stipulation in writing filed with the Board or presented at the hearing, may agree upon any facts involved in a proceeding. Stipulations filed need not be formally offered to be considered in evidence. Written stipulations shall be filed in duplicate. Duplicates of exhibits appended to the stipulation need not be provided unless requested.

(*c*) *Depositions must be offered.*—Testimony taken by deposition will not be considered until offered and received in evidence.

(*d*) *Documentary evidence.*—(1) When books, records, papers, or documents have been received in evidence, a copy thereof or of so much thereof as may be material or relevant may, in the discretion of the division holding the hearing, be substituted therefor.

(2) After the decision of the Board in any proceeding has become final, the Board may, upon motion, permit the withdrawal by the party entitled thereto of original exhibits, or the Board may, on its own motion, make such other disposition thereof as it deems advisable.

(*e*) *Not evidence.*—Statements in the petition, ex parte affidavits, and briefs do not constitute evidence.

(*f*) *Failure of proof.*—Failure to adduce evidence in support of the material facts alleged in the petition and denied by the Commissioner in his answer will be ground for dismissal. Where there is a joinder of issue on questions of fact, the provisions of rule 30 do not relieve the party upon whom rests the burden of proof from properly producing evidence to support the issues.

RULE 32. BURDEN OF PROOF.

The burden of proof shall be upon the petitioner, except as otherwise provided by statute, and except that in respect of any new matter pleaded in his answer, it shall be upon the respondent.

RULE 35. BRIEFS.

The parties should be prepared to make oral arguments at the conclusion of the hearing or to file written citations of authorities at that time if the division so directs. The filing of briefs and the making of oral arguments shall be in accordance with the directions of the member presiding at the hearing. If the division does not direct otherwise, each party shall have 45 days after the day on which the hearing was concluded within which to file a brief and either party may file a reply brief within 15 days after the filing of the original brief by his opponent. After a brief has been filed, the clerk will serve a copy upon the opposite party, unless the brief bears a notation that a copy has already been served.

If briefs are typewritten, an original and four copies shall be filed; if printed, 20 copies. Each brief shall contain on its front flyleaf a table of contents with page references, supplemented by a list of all citations, alphabetically arranged as to cases cited, together with references to pages. Citations shall be in italics, when printed, and underscored, when typewritten.

The form of all briefs shall be as follows:

(*a*) A statement of the nature of the tax.

(*b*) The party having the burden of proof shall set forth complete statements of the facts based upon the evidence. Each statement shall be numbered, shall be complete in itself, and shall consist of a concise statement of the essential fact and not a discussion or argument relating to the evidence or the law. Reference to the pages of the transcript or the exhibits relied upon in support thereof shall be inserted after each separate statement.

If the other party disagrees with any or all of the statements of fact, he shall set forth each correction which he believes the evidence requires and shall give the same numbers to his statements of fact as appear in his opponent's brief. His statement of fact shall be set forth in accordance with the requirements above designated.

(*c*) A concise statement of the points upon which the party relies.

(*d*) *The argument.*—The argument shall set forth the points of law relied upon and any discussion of the evidence deemed necessary to support the statement of fact.

RULE 40.—TRANSCRIPTS OF PROCEEDINGS.

Hearings before the Board or its divisions shall be stenographically reported and a transcript thereof shall be made if, in the opinion of the Board or of the division holding the hearing, a permanent record of the hearing is deemed necessary. Transcripts shall be supplied to the parties and to the public by the official reporter at such rates as may be fixed by contract between the Board and the reporter.

RULE 44. SUBPENAS.

(*a*) *How issued.*—The party desiring a subpoena must make a timely application therefor, in writing.

(*b*) *Application for.*—The application shall state the name and address of each witness required, the time and place at which and the officer before whom he is to appear, and whether he may designate someone to appear in his place. An original and two conformed copies shall be filed. (See Appendix I, Form No. 3.)

(*c*) *For production of documents.*—If evidence other than oral testimony is required, such as documents or written data, the application shall set forth the specific matter to be produced and sufficient facts to indicate that such matter is reasonably necessary to establish the cause of action or defense of the applicant.

(*d*) *Service and proof.*—The Board will not serve subpoenas, but will leave service to be procured by the party making the application. Service may be made by any citizen of the United States over the age of 21 years and competent to be a witness, and not a party to or in any way interested in the proceeding. Proof of service may be made by affidavit.

RULE 45. DEPOSITIONS.

(*a*) *Application to take.*—When either party desires to take a deposition, he shall file with the Board a verified application and two conformed copies, together with an additional copy for each additional docket number involved. The Board upon request will furnish forms for this purpose. If the space in the form furnished by the Board is inadequate for setting forth the reasons in support of the application in any particular case, a substitute form may be used, but the substitute must contain all of the information called for on the Board's form. (See Appendix I, Form No. 5.)

(*b*) *Limitation on time for application to take.*—Applications to take depositions must be filed at least 30 days prior to the date set for the hearing of the proceeding, and such depositions must be completed and filed with the Board at least 10 days prior to the hearing: *Provided*, Such applications will not be regarded as sufficient ground for the granting of a continuance from the date or place of the hearing theretofore set, unless the proceeding shall have been at issue less than 60 days and the motion for continuance shall have been filed not less than 20 days prior to said date of hearing: *Provided further*, That under special circumstances, and for good cause shown, the Board may otherwise order.

(*c*) *Qualification of officer.*—This officer before whom depositions are taken must be authorized to administer oaths. Section 3632, I. R. C. In no case shall a deposition be taken before any person who has any office connection or business

employment with either party or his counsel except by consent of the parties and when no other officer is available, and in his certificate of return to such deposition such officer shall so certify.

(*d*) *Order for taking.*—Upon receipt of such application, the clerk will serve a copy thereof on the opposite party, and allow a reasonable time for objection thereto. Thereafter, the Board will, in its discretion, make an order, a copy of which will be mailed or delivered to the parties or their counsel, wherein the Board will name the witness whose deposition is to be taken and specify the time when, the place where, and the officer before whom the witness is to testify, but such time, place, and officer specified in the Board's order may or may not be the same as set forth in the application. The applicant shall thereupon make all necessary arrangements for the taking of each deposition and shall furnish the officer before whom it is to be taken with a copy of the order above mentioned.

(*e*) *By stipulation.*—At any time after issue is joined, the parties or their counsel may, by stipulation duly signed and filed, take depositions. In such cases, the stipulation shall state the name and address of each witness, the time when and the place where such depositions will be taken and the name, address, and official title of the officer before whom it is proposed to take the depositions. In such cases, no order to take depositions will be issued, but they shall be taken and returned by the officer in accordance with the rules of the Board.

(*f*) *Manner of taking.*—Each witness must first take the oath or affirm. The questions propounded to him and his answers must be recorded verbatim.

Objections to questions or answers shall be explicitly but briefly and concisely stated, but no comment, explanation, or argument of any kind shall be recorded; neither shall there be recorded any comment, explanation, or argument by examining counsel. Any matter reported in violation of this rule may be sufficient cause for the suppression of the deposition.

(*g*) *Other witnesses to be excluded.*—At the request of either party, a person whom either expects or intends to call as a witness in the same or any related proceeding shall be excluded from the room where the testimony of a witness is being taken. If such person remains in the room or within hearing of the examination after such request has been made, he shall not thereafter be permitted to testify except by the consent of the party who requested his exclusion.

(*h*) *Depositions to be signed.*—The testimony of the witness when transcribed shall be read to or by him and shall be signed by him. (See Appendix I, Form No. 6.)

(*i*) *Form in which depositions must be returned to the Board.*—When a deposition is returned to the Board it must show the docket number and the caption (the names of the parties) of the proceeding as appears in the Board's records, the place and date of taking, the name of the witness, the party by whom called, the names of counsel present, indicating which party each counsel represents, and (in the body of the deposition) the name of counsel examining or cross-examining the witness.

The officer must so fasten the sheets of the deposition that they can not be tampered with. He must spare no pains to return to the Board the exact testimony he has taken. All exhibits must be carefully marked so as to be capable of identification, and when practicable must be attached to the deposition.

The officer must properly execute and attach to the deposition a certificate of return in the form prescribed. (See Appendix I, Form No. 6.)

(*j*) *Return of.*—The officer must enclose the original depositions and exhibits, together with two copies of the depositions, in a sealed packet, with postage or other transportation charges prepaid, and direct and forward the same to the United States Board of Tax Appeals, Washington, D. C. In each case, the original of the depositions must be directed and forwarded to the Board. The officer may, however, upon written request, deliver a copy of the depositions to either or to both of the parties, or to their representatives, in lieu of sending such copies to the Board as above provided. If one or both of the required copies are delivered by the officer taking the depositions, he shall attach to his return the written request of the party or parties, or of their counsel to whom such copy or copies were delivered, and shall state in his certificate of return the fact of delivery by him of such copy or copies. If copies of the depositions are delivered by the officer taking the same, no service of copies of such depositions upon the party or his counsel of record will be made by the Board.

(*k*) The deposition of any witness shall not constitute a part of the record until received in evidence. (See rule 31.)

RULE 46. DEPOSITIONS UPON WRITTEN INTERROGATORIES.

Depositions may be taken in the discretion of the Board upon written interrogatories in substantially the same manner as provided in rule 45 for depositions upon oral examination. An original and five copies of the interrogatories must be filed with the application. The clerk will serve one copy of the application and of the interrogatories upon the opposite party. If the opposite party desires to file objections or cross-interrogatories, he must do so within 10 days after the application and interrogatories have been served upon him. Cross-interrogatories must consist of an original and five copies. The clerk will serve one copy thereof upon the opposite party who, if he has any objection thereto, must file his objections within 10 days thereafter. No objections to the interrogatories or cross-interrogatories will be considered at the hearing unless timely filed in accordance with this rule.

No person other than the witness, a stenographic reporter, and the officer taking the deposition upon written interrogatories and cross-interrogatories shall be present at the examination of the witness. This fact shall be certified by the officer taking the deposition. That officer shall propound the interrogatories and cross-interrogatories to the witness in their order and cause the testimony to be reduced to writing in the witness's own words.

Depositions obtained in foreign countries must be taken upon written interrogatories, except as otherwise directed by the Board for cause shown.

RULE 50. COMPUTATIONS BY PARTIES FOR ENTRY OF DECISION.

Where the Board has promulgated or entered its opinion determining the issues in a proceeding, it may withhold entry of its decision for the purpose of permitting the parties to submit computations pursuant to the Board's determination of the issues, showing the correct amount of the deficiency or overpayment to be entered as the decision. If the parties are in agreement as to the amount of the deficiency or overpayment to be entered as the decision pursuant to the report of the Board, they or either of them shall file promptly with the Board an original and two copies of a computation showing the amount of the deficiency or overpayment and that there is no disagreement that the figures shown are in accordance with the decision of the Board. The Board will then enter its decision. If, however, the parties are not in agreement as to the amount of the deficiency or overpayment to be entered as the decision, in accordance with the report of the Board, either of them may file with the Board a computation of the deficiency or overpayment believed by him to be in accordance with the report of the Board. The clerk will serve a copy thereof upon the opposite party, will place the matter upon the hearing calendar for argument in due course, and will serve notice of the argument upon both parties If the opposite party fails to file objection, accompanied by an alternative computation, at least five days prior to the date of such argument, or any continuance thereof, the Board may enter decision in accordance with the computation already submitted. If in accordance with this rule computations are submitted by the parties which differ as to the amount to be entered as the decision of the Board, the parties will be afforded an opportunity to be heard in argument thereon on the date fixed, and the Board will determine the correct deficiency or overpayment and enter its decision.

Any argument under this rule will be confined strictly to the consideration of the correct computation of the deficiency or overpayment resulting from the report already made, and no argument will be heard upon or consideration given to the issues or matters already disposed of by such report or of any new issues. This rule is not to be regarded as affording an opportunity for rehearing or reconsideration.

RULE 51. COSTS—PREPARATION OF RECORD ON REVIEW.

Immediately after the contents of a record on review have been settled or agreed to, the clerk will notify the petitioner of the costs and charges for the preparation, comparison, and certification of said records; such charges to be determined in accordance with the provisions of an Act of Congress entitled "An Act to provide fees to be charged by clerks of the district courts of the United States," approved February 11, 1925 (43 Stat., 857–858; U. S. C., Title 28, sections 548–554).

No transcript will be certified and transmitted to the appellate court until the costs and charges therefor have been paid.

A petitioner for review who requests the clerk to certify but not to prepare documents for transmission to a United States Circuit Court of Appeals or to the United States Court of Appeals for the District of Columbia shall furnish the clerk with the copies of the documents to be certified.

RULE 52. COSTS—PRINTING OF RECORD ON REVIEW.

In each proceeding for review of a decision of the Board by the United States Circuit Court of Appeals for the Second Circuit when review is sought by the Commissioner of Internal Revenue, the clerk of the Board shall, immediately after the contents of the record on review, as required by rule 35 of the court, have been settled or agreed upon, make available to the Commissioner, or his counsel, the record of the Board in the proceeding. The Commissioner shall cause the record to be printed. Twenty-five copies of the printed record shall be delivered to the clerk of this Board for certification and for filing with the clerk of the circuit court of appeals. The clerk of the Board shall serve three copies of the printed record upon counsel for the taxpayer.

RULE 53. COPIES OF BOARD RECORDS—FEES FOR FURNISHING.

A plain or a certified copy of any document, record, entry, or other paper may be had upon application to the Board, the fee to be charged and collected therefor to be determined in accordance with the provisions of the Act of Congress entitled "An Act to provide fees to be charged by clerks of the district courts of the United States," approved February 11, 1925 (43 Stat., 857–858; U. S. C., Title 28, sections 548–554).

RULE 60. FEES AND MILEAGE.

Title X of the Revenue Act of 1926 provides in part:

"SEC. 909. (a) Any witness summoned or whose deposition is taken under section 908 shall receive the same fees and mileage as witnesses in courts of the United States. Such fees and mileage and the expenses of taking any such deposition shall be paid as follows:

"(1) In the case of witnesses for the Commissioner, such payments shall be made by the Secretary out of any moneys appropriated for the collection of internal-revenue taxes, and may be made in advance.

"(2) In the case of any other witnesses, such payments shall be made, subject to rules prescribed by the Board, by the party at whose instance the witness appears or the deposition is taken."

No witness, other than one for the Commissioner, shall be required to testify in any proceeding before the Board until he shall have been tendered the fees and mileage to which he is entitled in accordance with the above provision of law.

RULE 61. COMPUTATION OF TIME—SUNDAYS AND HOLIDAYS.

Whenever these rules prescribe a time for the performance of any act, Sundays and legal holidays in the District of Columbia shall count just as any other days, except that when the time prescribed for the performance of an act expires on a Sunday or a legal holiday in the District of Columbia, such time shall extend to and include the next succeeding day that is not a Sunday or such a legal holiday: *Provided*, That when the time for performing any act is prescribed by statute nothing in these rules shall be deemed to be a limitation or extension of the statutory time period.

The following-named days are legal holidays within the District of Columbia:

New Year's Day, January 1 (U. S. C., Title 5, section 87).

Inauguration Day, every fourth year (48 Stat., 879; D. C. Code, Title 22, section 126).

Washington's Birthday, February 22 (U. S. C., Title 5, section 87).

Decoration Day, May 30 (U. S. C., Title 5, section 87).

Fourth of July (U. S. C., Title 5, section 87).

Labor Day, first Monday in September (U. S. C., Title 5, section 87).

Armistice Day, November 11 (52 Stat., 351).

Thanksgiving Day, day proclaimed by the President (section 993, R. S., relating to D. C.; D. C. Code, Title 22, section 126).

Christmas Day, December 25 (U. S. C., Title 5, section 87).

When legal holidays fall on Sunday the next day shall be a holiday (22 Stat., 1; D. C. Code, Title 22, section 126).

RULE 62. SPECIAL ASSESSMENT.

(*a*) If some of the issues raised by the petition involve section 327 or section 328 of the Revenue Act of 1918 or of 1921 [or section 210 of the Revenue Act of 1917, as the case may be], and some do not involve such sections, the hearing may, in the discretion of the Board, on motion, be limited in the first instance to trial of the issues which do not involve such sections.

(*b*) A hearing may be had in the discretion of the Board, on motion, limited to the trial of the issue whether the petitioner is entitled to have its tax determined as provided in section 328 [or section 210, as the case may be].

(*c*) If the Board decides that the petitioner is entitled to have its tax determined as provided in section 328 [or section 210, as the case may be], the respondent shall within 60 days after such decision file with the Board an original and two copies of a proposed redetermination showing the method of the computation. If, within 20 days after service by the clerk upon the petitioner of a copy of such proposed redetermination, the parties are unable to agree upon the amount of tax, either party may move, or the Board may upon its own motion order, that the proceeding be placed upon the calendar for further hearing, at which either party may submit proof of the correct amount of tax and deficiency or overpayment.

(*d*) If from the pleadings or otherwise it appears of record before the Board that the parties agree that petitioner is entitled to have its tax determined as provided in section 328 [or section 210, as the case may be], and the only issue is as to the correct amount of the tax so determined, the proceeding will be placed upon the calendar in due course for hearing, at which either party may submit proof of the correct amount of the tax and deficiency or overpayment.

RULE 70. EFFECTIVE DATE.

These rules shall become effective April 1, 1941, superseding all prior editions and amendments.

APPENDIX.

I. FORMS.

These forms are subject to amendment as circumstances may render necessary.

No. 2. Petition.
No. 3. Application for subpena.
No. 5. Application for order to take depositions.
No. 6. Certificate on return of depositions.

(NOTE.—Read rule 4 of the rules of practice of the Board and carefully observe the requirements thereof as to form, size, and style of papers.)

No. 2.—PETITION.

(See rules 4, 5, 6, 7, and 8.)

UNITED STATES BOARD OF TAX APPEALS.

----------, *petitioner*, v. *Commissioner of Internal Revenue, respondent.*	Docket No.

PETITION.

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau symbols) dated ----------, 19---, and as a basis of his proceeding alleges as follows:

1. The petitioner is (set forth whether individual, corporation, fiduciary, etc., as provided in rule 6) with principal office (or residence) at ---------- (Street.) ---------- (City.) (State.) The return for the period here involved was filed with the collector for the ------ district of ----------

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on ----------, 19---.

3. The taxes in controversy are (income, profits, estate, or gift) taxes for the (calendar or fiscal year) year 19___ and in the amount of _____ dollars (state as exactly as possible the amount in dispute).

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors: (Enumerate specifically the assignments of error in a concise manner and avoid pleading facts which properly belong in the succeeding paragraph.)

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows: (Here set forth allegations of the facts relied upon—but not the evidence—in orderly and logical sequence, with subparagraphs lettered, so as fully to inform the Board of the issues to be presented and to enable the Commissioner to admit or deny each specific allegation.)

Wherefore, the petitioner prays that this Board may hear the proceeding and (Here state the relief desired).

(Signed) _____,
(Petitioner or counsel.)

_____
(Post-office address.)

STATE OF _____ *ss:*
County of _____

_____, being duly sworn, says that he is the petitioner (if a corporation, or fiduciary, state title of office or trust of person verifying and that he is duly authorized to verify the foregoing petition) above named; that he has read the foregoing petition, or had the same read to him, and is familiar with the statements contained therein, and that the statements contained therein are true, except those stated to be upon information and belief, and that those he believes to be true.

(Signed) _____

Subscribed and sworn to before me this _____ day of _____, 19____.

(Signed) _____
(Official title.)

[SEAL]

No. 3.—APPLICATION FOR SUBPENA.

_____, *petitioner,*
v.
Commissioner of Internal Revenue, respondent.
} Docket No.

To the United States Board of Tax Appeals:

Application is hereby made for the issuance of a subpena for the attendance before _____
(The United States Board of Tax Appeals or the name and official title of the person authorized to take depositions.)
at _____ on _____
at _____ o'clock _____ m. of the following persons whose oral testimony is desired on behalf of the _____ in the above-entitled
(Petitioner or respondent.)
proceeding:

NAME.	ADDRESS.
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____

Dated _____, 19____.

(Signed) _____
(Post-office address) _____
_____

No. 5.—APPLICATION FOR ORDER TO TAKE DEPOSITIONS.

(See rules 45 and 46.)

UNITED STATES BOARD OF TAX APPEALS.

_____, *petitioner*,
v.
Commissioner of Internal Revenue, respondent.
} Docket No.

APPLICATION FOR ORDER TO TAKE DEPOSITIONS.

To the United States Board of Tax Appeals:

1. Application is hereby made by the above-named _____ (Petitioner or respondent.) for an order to take the deposition__ of the following-named person__:

NAME OF WITNESS.	POST-OFFICE ADDRESS.
(a)_____	_____
(b)_____	_____
(c)_____	_____
(d)_____	_____

2. It is desired to take the depositions of the persons above named and each of them for the following reasons:

(a) _____will testify to the following material matters:

_____

_____

(Set forth briefly the matter upon which said witness will be called to testify.)

(b) _____ will testify to the following material matters:

_____

_____

(c)_____ will testify to the following material matters:

_____

_____

(d) _____ will testify to the following material matters:

_____

_____

3. The reasons why _____ (Petitioner or respondent.) desires to take the testimony of the above-named persons rather than have them appear personally and testify before the Board are as follows: (State specifically reasons for each witness.)

4. It is desired to take the testimony of _____ (Names of witnesses.)

_____

on the _____ day of _____, 19____, at the hour of _____ o'clock ____ m.
(A date sufficiently in advance of the day set for hearing of the proceedings to enable the deposition to be completed and filed with the Board at least 10 days prior to the hearing.)

before _____ (State name and title of official.) in the city of _____,

State of _____ at room _____ (Give number of room, street

_____

number, and name of building.)

5. That _____ is a
(Name of official before whom depositions are to be taken.)
_____, who has no office connection or business employ-
(Give official title.)
ment with the petitioner or his counsel.

Dated _____, 19___.

(Signed) _____
(Petitioner or counsel.)

_____
(Post-office address.)

STATE OF _____ *ss:*
County of _____

_____, being duly sworn, says that the fore-
(Petitioner or counsel.)
going application for order to take depositions is made in good faith and for the reasons therein stated and that the same is not made for purposes of delay.

(Signed) _____

Subscribed and sworn to before me this _____ day of _____, 19__.

(Signed) _____
(Official title.)

[SEAL]

No. 6.—CERTIFICATE ON RETURN.

To the United States Board of Tax Appeals:

I, _____, the person named in the foregoing order to take depositions, hereby certify:

1. That I proceeded, on the _____ day of _____, A. D. 19___, at the office of _____, in the city of _____, State of _____, at _____ o'clock __m., under the said order and in the presence of _____ and _____ the counsel of the respective parties, to take the following depositions, viz:

_____, a witness produced on behalf of the _____;
(Petitioner or respondent.)

_____, a witness produced on behalf of the _____;
(Petitioner or respondent.)

_____, a witness produced on behalf of the _____;
(Petitioner or respondent.)

2. That each witness was examined under oath at such times and places as conditions of adjournment required, and that the testimony of each witness (or his answers to the interrogatories filed) was taken stenographically and reduced to typewriting by me or under my direction.

3. That after the testimony of each witness had been reduced to writing the transcript of that testimony was read and signed by the witness in my presence, and that each witness acknowledged before me that his testimony was in all respects truly and correctly transcribed.

4. That, after the signing of the deposition in my presence, no alterations or changes were made therein.

5. That I have no office connection or business employment with the petitioner or his attorney except that _____, objection to which was
(State connection.)
waived by both parties to the proceeding.

[SEAL]

_____
(Signature of person taking deposition.)

_____
(Official title.)

_____
(Post-office address.)

NOTE.—This form when properly executed should be attached to and bound with the transcript preceding the first page thereof. It should then be enclosed in a sealed envelop and addressed to United States Board of Tax Appeals, Washington, D. C.

II. Requests for Place of Hearing.

The Board will fix the times and places for its hearings in order to secure reasonable opportunity to taxpayers to be heard with as little inconvenience and expense to taxpayers as is practicable. (Section 1105, I. R. C.) Hearings may be held at any place requested if suitable accommodations are available and a sufficient number of cases are ready for hearing there. A partial list of cities where a combination of these circumstances has justified a calendar of hearings recently appears below. It is published here merely to assist parties in making requests under rule 26. The grouping of certain cities in the list indicates that if one of those cities is requested, it may be necessary to hold the hearing at the other city in order to make up a sufficient calendar of hearings. Likewise, if sufficient cases are not ready for hearing in any particular city requested by taxpayers, or if suitable quarters are not available there, the Board may find it necessary to combine the hearings requested for that city and hold them along with the hearings requested for some other city in the vicinity.

LIST.

Alabama:
- Birmingham.
- Mobile.

Arkansas: Little Rock (alternative, Memphis, Tenn.).

California:
- Los Angeles.
- San Francisco.

Colorado: Denver.

District of Columbia: Washington.

Florida:
- Jacksonville.
- Miami.
- Tampa (alternative, Miami).

Georgia: Atlanta.

Hawaii: Honolulu (alternative, Los Angeles or San Francisco, Calif.)

Illinois: Chicago.

Indiana: Indianapolis.

Iowa: Des Moines.

Kentucky: Louisville.

Louisiana:
- New Orleans.
- Shreveport.

Maine: Portland (alternative, Boston, Mass.)

Massachusetts: Boston.

Michigan:
- Detroit.
- Grand Rapids.

Minnesota: St. Paul.

Missouri:
- Kansas City.
- St. Louis.

Montana: Helena.

Nebraska: Omaha.

New Jersey: Newark.

New York:
- Buffalo.
- New York City.

North Carolina:
- Greensboro.
- Raleigh.

Ohio:
- Cincinnati (alternative, Columbus).
- Cleveland.
- Columbus (alternative, Cincinnati).

Oklahoma:
- Oklahoma City (alternative, Tulsa).
- Tulsa (alternative, Oklahoma City).

Oregon: Portland.

Pennsylvania:
- Philadelphia (alternative, Washington, D. C., or New York, N. Y.).
- Pittsburgh.

South Carolina:
- Charleston.
- Columbia.

Tennessee:
- Knoxville (alternative, Atlanta, Ga.).
- Memphis.
- Nashville.

Texas:
- Dallas.
- Houston.

Utah: Salt Lake City.

Washington:
- Seattle.
- Spokane.

West Virginia: Charleston.

Wisconsin:
- Madison (alternative, Milwaukee).
- Milwaukee.

MISCELLANEOUS.

1941-11-10645
Mim. 4298 (Rev.)

Symbols for use in correspondence.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C., February 28, 1941.

Collectors of Internal Revenue; Internal Revenue Agents in Charge; District Supervisors; Heads of Field Divisions, Technical Staff; Special Agents in Charge; Deputy Commissioners; and Other Officers and Employees of the Bureau of Internal Revenue Concerned:

The following directions supersede those contained in Mimeograph 4298 (revised), dated March 25, 1940 [C. B. 1940-1, 296], and all other instructions in conflict therewith. Section 63(6), Part I, of the Internal Revenue Manual is, also, amended to conform to the following:

Every letter prepared in the Bureau in Washington will bear in the upper left-hand corner of the first page, and immediately below the wording "Address reply to," etc., a symbol that will indicate the office of origin; provided, that this practice will not apply to Congressional correspondence, or to letters prepared for the signatures of others than officials of the Bureau.

Every letter addressed to the Bureau by a field office, if it is in reply to a communication from the Bureau, will bear, immediately above the body of the letter and near the center of the first page, the symbol that appears in the communication that is being answered; thus "Attention: Ad:PB." If the letter is not in reply to a Bureau communication, the symbol of the unit, division, or section of the Bureau concerned will be indicated in the same manner, provided there is no question as to the proper symbol; *if any doubt exists, no symbol whatever will be used.*

Where a field office uses a system of symbols in conducting its correspondence, the appropriate symbol will be placed in the upper left-hand corner of the first sheet, just below the wording "In replying refer to," of each letter addressed to the Bureau. The Bureau letter, if any, replying to such communication will show the field office symbol above the body of the letter in the same manner as is prescribed in the next preceding paragraph.

Closed, and not window, envelopes with printed or typewritten address will be used by field offices in transmitting mail to the Bureau. Every such envelope, or other wrapper, will bear in the lower left hand corner of the face thereof the same symbol that is quoted in the communication which it incloses. There is no objection to forwarding in one envelope a number of communications intended for the same unit or division of the Bureau; in fact this is desirable, except that instructions contained in A&C Circular 1248, dated May 28, 1938, regarding the separation of matter relating to employment taxes from other mail for the Accounts and Collections Unit should be complied with. Under no circumstances, however, should corre-

spondence pertaining to the work of one unit be inclosed in an envelope addressed to another unit.

Information which will assist field officers in determining the destination of correspondence that is not in reply to Bureau letters may be obtained by directing an inquiry to the Administrative Division, attention Communication Section.

Only one subject will be treated in any one letter.

The following represents the organization and symbols used:

OFFICE OF THE COMMISSIONER.

Ad—Administrative Division.
Ad: C—Communication Section.
Ad: PB—Printing and Binding Section.
Ad: SL—Space and Lease Section.
Ad: SE—Supplies and Equipment Section.
P—Personnel Division.
Pub. Rel.—Public Relations Division.
SD—Special Deputy Commissioner.
SD: Tn—Training Division.
TS—Technical Staff.

ACCOUNTS AND COLLECTIONS UNIT.

A&C: DC—Deputy Commissioner.
A&C: AD—Assistant Deputy Commissioner.
A&C: EA—Executive Assistant.
A&C: EmT—Chief, Employment Tax Activities.
A&C: TA—Technical Assistants.
A&C: D—Disbursement Accounting Division.
A&C: Col—Collection Accounting Division.
A&C: PES—Collectors' Personnel, Equipment, and Space Division.

AUDIT DIVISION.

A&C: A—Head of Division.
A&C: A: AA—Audit and Adjustment Section.
A&C: A: E—Examining Section.
A&C: A: F—Files Section.
A&C: A: F: RB&R—Bankruptcy Unit.

RULES AND REGULATIONS DIVISION.

A&C: RR—Head of Division.
A&C: RR: 1—Section 1.
A&C: RR: 2—Section 2.
A&C: RR: 3—Section 3.

SERVICE DIVISION.

A&C: S—Head of Division.
A&C: S: F—Files Section.
A&C: S: S—Stenographic Section.

CONTROL DIVISION.

A&C: C—Head of Division.
A&C: C: A—Assessment Section.
A&C: C: CC—Claims Control Section.

ALCOHOL TAX UNIT.

AT: DC—Deputy Commissioner.
AT: L—Legal Division.

ENFORCEMENT.

AT: E—Assistant Deputy Commissioner.
AT: EX—Examining Section.
AT: PP—Pardon and Parole Section.
AT: EF—Enforcement Files Section.
AT: RM—Raw Materials Section.

PERMISSIVE AND ADMINISTRATIVE.

AT: P—Assistant Deputy Commissioner.
AT: FI—Field Inspection Division.
AT: PS—Personnel and Supply Division.
AT: PR—Procedure Division.
AT: S—Statistical Section.
AT: A—Audit Division.
AT: BA—Bonded Accounts Section.
AT: T—Tax Section.
AT: LB—Laboratory Division.

BASIC PERMIT AND TRADE PRACTICE.

AT: BP—Assistant Deputy Commissioner.
AT: BP: L—Labels Section.

OFFICE OF THE CHIEF COUNSEL.

GC: E—Chief Counsel.
GC: A—Appeals Division.
GC: C—Civil Division.
GC: C: C—Compromise Section.
GC: I—Interpretative Division.
Digest Section.
GC: L&R—Legislation and Regulations Division.
GC: P—Penal Division.
GC: R—Review Division.
Executive.
GC: E&A—Engineers and Auditors Section.
GC: RBR—Reorganization Section.
GC: M&R—Mail and Records Section.

INCOME TAX UNIT.

IT—Deputy Commissioner.
Assistant Deputy Commissioner.
IT: R: A—Audit Review Division A (New York).
IT: R: B—Audit Review Division B (Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, Pennsylvania, Rhode Island, Vermont).
IT: R: C—Audit Review Division C (Alabama, Delaware, District of Columbia, Florida, Georgia, Kentucky, Maryland, Michigan, North Carolina, Ohio, South Carolina, Tennessee, Virginia, West Virginia).
IT: R: D—Audit Review Division D (Colorado, Illinois, Indiana, Iowa, Kansas, Minnesota, Missouri, Nebraska, New Mexico, North Dakota, South Dakota, Wisconsin, Wyoming).
IT: R: E—Audit Review Division E (Alaska, Arizona, Arkansas, California, Hawaii, Idaho, Louisiana, Mississippi, Montana, Nevada, Oklahoma, Oregon, Texas, Utah, Washington).
IT: R: E: Aj—Special Adjustment.

CLEARING DIVISION.

IT: Cl—Head of Division.
IT: Cl: CC—Claims Control Section.
IT: Cl: D—Returns Distribution Section.
IT: Cl: P—Proving Section.
IT: Cl: St—Statistical Section.

ENGINEERING AND VALUATION DIVISION.

IT: EV—Head of Division.
IT: EV: Ap—Appraisal Section.
IT: EV: NR—Natural Resources Section.
IT: EV: PU—Public Utilities Section.
IT: EV: Se—Securities Section.

FIELD PROCEDURE DIVISION.

IT:F—Field Procedure Division.

PRACTICE AND PROCEDURE DIVISION.

IT:P—Head of Division.
IT:P:IR—Bureau Information and Rulings Section.
IT:P:CA—Coordinating and Advisory Section.
IT:P:T—Taxpayers' Rulings Section.
IT:P:T:1—Group 1.
IT:P:T:2—Group 2.

RECORDS DIVISION.

IT:Rec—Head of Division.
IT:Rec:F—Files Section.
IT:Rec:IW—Returns Inspection and Withholding Returns Section.

SERVICE DIVISION.

IT:S—Service Division.

UNJUST ENRICHMENT DIVISION.

IT:UE—Head of Division.
IT:UE:AR—Audit and Review Section.
IT:UE:Conf—Conference Section.
IT:UE:I—Invalidity Claims Section.

INTELLIGENCE UNIT.

SI—Chief, Intelligence Unit.

MISCELLANEOUS TAX UNIT.

MT:DC—Deputy Commissioner.
MT:CST—Capital Stock Tax Division.
MT:ET—Estate Tax Division.
MT:PT—Processing Tax Division.
MT:ST—Sales Tax Division.
MT:T—Tobacco Division.

GUY T. HELVERING,
Commissioner.

LEGISLATION.

EXCESS-PROFITS TAX AMENDMENTS OF 1941.

1941–11–10647

H. R. 3531. PUBLIC LAW 10, SEVENTY-SEVENTH CONGRESS [CHAPTER 10, FIRST SESSION].

An Act To amend certain provisions of the Internal Revenue Code relating to the excess profits tax, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Excess Profits Tax Amendments of 1941".

SEC. 2. UNUSED EXCESS PROFITS CREDIT.

(a) Section 710(b)(3) of the Internal Revenue Code is amended to read as follows:

"(3) UNUSED EXCESS PROFITS CREDIT.—The amount of the excess profits credit carry-over for the taxable year, computed in accordance with subsection (c)."

(b) COMPUTATION OF EXCESS PROFITS CREDIT CARRY-OVER.—Section 710 of the Internal Revenue Code is amended by adding at the end thereof the following new subsection:

"(c) EXCESS PROFITS CREDIT CARRY-OVER.—

"(1) DEFINITION OF UNUSED EXCESS PROFITS CREDIT.—The term 'unused excess profits credit' means the excess, if any, of the excess profits credit for any taxable year beginning after December 31, 1939, over the excess profits net income for such taxable year, computed on the basis of the excess profits credit applicable to such taxable year.

"(2) COMPUTATION OF EXCESS PROFITS CREDIT CARRY-OVER.—The excess profits credit carry-over for any taxable year shall be the sum of the following:

"(A) The unused excess profits credit for the first preceding taxable year; and

"(B) The unused excess profits credit for the second preceding taxable year reduced by the amount, if any, by which the excess profits net income for the first preceding taxable year exceeds the sum of—

"(i) the excess profits credit for such first preceding taxable year, plus

"(ii) the unused excess profits credit for the third preceding taxable year."

SEC. 3. ABNORMAL DEDUCTION IN BASE PERIOD.

Sections 711(b)(1) (G), (H), and (I), of the Internal Revenue Code are amended to read as follows:

"(G) Dividends Received.—The credit for dividends received shall apply, without limitation, to dividends on stock of domestic corporations;

"(H) Payment of Judgments, and So Forth.—Deductions attributable to any claim, award, judgment, or decree against the taxpayer, or interest on any of the foregoing, if abnormal for the taxpayer, shall not be allowed, and if normal for the taxpayer, but in excess of 125 per centum of the average amount of such deductions in the four previous taxable years, shall be disallowed in an amount equal to such excess;

"(I) Intangible Drilling and Development Costs.—Deductions attributable to intangible drilling and development costs paid or incurred in or for the drilling of wells or the preparation of wells for the production of oil or gas, and for development costs in the case of mines, if abnormal for the taxpayer, shall not be allowed, and if normal for the taxpayer, but in excess of 125 per centum of the average amount of such deductions in the four previous taxable years, shall be disallowed in an amount equal to such excess; and

"(J) Abnormal Deductions.—Under regulations prescribed by the Commissioner, with the approval of the Secretary, for the determination, for the purposes of this subparagraph, of the classification of deductions—

"(i) Deductions of any class shall not be allowed if deductions of such class were abnormal for the taxpayer, and

"(ii) If the class of deductions was normal for the taxpayer, but the deductions of such class were in excess of 125 per centum of the average amount of deductions of such class for the four previous taxable years, they shall be disallowed in an amount equal to such excess.

"(K) Rules for Application of Subparagraphs (H), (I), and (J).—For the purposes of subparagraphs (H), (I), and (J)—

"(i) If the taxpayer was not in existence for four previous taxable years, then such average amount specified in such subparagraphs shall be determined for the previous taxable years it was in existence and the succeeding taxable years which begin before the beginning of the taxpayer's second taxable year under this subchapter. If the number of such succeeding years is greater than the number necessary to obtain an aggregate of four taxable years there shall be omitted so many of such succeeding years, beginning with the last, as are necessary to reduce the aggregate to four.

"(ii) Deductions shall not be disallowed under such subparagraphs unless the taxpayer establishes that the abnormality or excess is not a consequence of an increase in the gross income of the taxpayer in its base period or a decrease in the amount of some other deduction in its base period, and is not a consequence of a change at any time in the type, manner of operation, size, or condition of the business engaged in by the taxpayer.

"(iii) The amount of deductions of any class to be disallowed under such subparagraphs with respect to any taxable year shall not exceed the amount by which the deductions of such class for such taxable year exceed the deductions of such class for the taxable year for which the tax under this subchapter is being computed."

SEC. 4. COMPUTATION OF AVERAGE BASE PERIOD NET INCOME.

(a) Section 713(a)(1) of the Internal Revenue Code is amended by striking out "subsection (b)" and inserting in lieu thereof "subsection (d)", and by striking out "subsection (c)" wherever occurring therein and inserting in lieu thereof "subsection (g)".

(b) Section 713(b) of the Internal Revenue Code is amended to read as follows:

"(b) BASE PERIOD.—

"(1) DEFINITION.—As used in this section the term 'base period'—

"(A) If the corporation was in existence during the whole of the forty-eight months preceding the beginning of its first taxable year under this subchapter, means the period commencing with the beginning of its first taxable year beginning after December 31, 1935, and ending with the close of its last taxable year beginning before January 1, 1940; and

"(B) In the case of a corporation which was in existence during only part of the forty-eight months preceding the beginning of its first taxable year under this subchapter, means the forty-eight months preceding the beginning of its first taxable year under this subchapter.

"(2) DIVISION INTO HALVES.—For the purposes of subsections (d) and (f) the base period of the taxpayer shall be divided into halves, the first half to be composed of one-half the entire number of months in the base period and to begin with the beginning of the base period.

"(c) DEFICIT IN EXCESS PROFITS NET INCOME.—For the purposes of this section the term 'deficit in excess profits net income' with respect to any taxable year means the amount by which the deductions plus the credit for dividends received exceeded the gross income. For the purposes of this subsection in determining whether there was such an excess and in determining the amount thereof, the adjustments provided in section 711(b)(1) shall be made.

"(d) AVERAGE BASE PERIOD NET INCOME—DETERMINATION.—

"(1) DEFINITION.—For the purposes of this section the average base period net income of the taxpayer shall be the amount determined under subsection (e), subject to the exception that if the aggregate excess profits net income for the last half of its base period, reduced by the aggregate of the deficits

in excess profits net income for such half, is greater than such aggregate so reduced for the first half, then the average base period net income shall be the amount determined under subsection (f), if greater than the amount determined under subsection (e).

"(2) For the purposes of subsections (e) and (f), if the taxpayer was in existence during only part of the 48 months preceding the beginning of its first taxable year under this subchapter, its excess profits net income—

"(A) for each taxable year of twelve months (beginning with the beginning of its base period) during which it was not in existence, shall be an amount equal to 8 per centum of the excess of—

"(i) the daily invested capital for the first day of the taxpayer's first taxable year beginning after December 31, 1939, over

"(ii) an amount equal to the same percentage of such daily invested capital as is applicable under section 720 in reduction of the average invested capital of the preceding taxable year;

"(B) for the taxable year of less than twelve months consisting of that part of the remainder of its base period during which it was not in existence, shall be the amount ascertained for a full year under subparagraph (A), multiplied by the number of days in such taxable year of less than twelve months and divided by the number of days in the twelve months ending with the close of such taxable year.

"(3) In no case shall the average base period net income be less than zero.

"(4) For the computation of average base period net income in the case of certain reorganizations, see section 742.

"(e) AVERAGE BASE PERIOD NET INCOME—GENERAL AVERAGE.—The average base period net income determined under this subsection shall be determined as follows:

"(1) By computing the aggregate of the excess profits net income for each of the taxable years of the taxpayer in the base period, reduced, if for more than one of such taxable years there was a deficit in excess profits net income, by the sum of such deficits, excluding the greatest;

"(2) By dividing the amount ascertained under paragraph (1) by the total number of months in all such taxable years; and

"(3) By multiplying the amount ascertained under paragraph (2) by twelve.

"(f) AVERAGE BASE PERIOD NET INCOME—INCREASED EARNINGS IN LAST HALF OF BASE PERIOD.—The average base period net income determined under this subsection shall be determined as follows:

"(1) By computing, for each of the taxable years of the taxpayer in its base period, the excess profits net income for such year, or the deficit in excess profits net income for such year;

"(2) By computing for each half of the base period the aggregate of the excess profits net income for each of the taxable years in such half, reduced, if for one or more of such years there was a deficit in excess profits net income, by the sum of such deficits. For the purposes of such computation, if any taxable year is partly within each half of the base period there shall be allocated to the first half an amount of the excess profits net income or defict in excess profits net income, as the case may be, for such taxable year, which bears the same ratio thereto as the number of months falling within such half bears to the entire number of months in such taxable year; and the remainder shall be allocated to the second half;

"(3) If the amount ascertained under paragraph (2) for the second half is greater than the amount ascertained for the first half, by dividing the difference by two;

"(4) By adding the amount ascertained under paragraph (3) to the amount ascertained under paragraph (2) for the second half of the base period;

"(5) By dividing the amount found under paragraph (4) by the number of months in the second half of the base period and by multiplying the result by twelve;

"(6) The amount ascertained under paragraph (5) shall be the average base period net income determined under this subsection, except that the average base period net income determined under this subsection shall in no case be greater than the highest excess profits net income for any taxable year in the base period. For the purpose of such limitation if any taxable year is of less than twelve months, the excess profits net income for such

taxable year shall be placed on an annual basis by multiplying by twelve and dividing by the number of months included in such taxable year.

"(7) For the purposes of this subsection, the excess profits net income for any taxable year ending after May 31, 1940, shall not be greater than an amount computed as follows:

"(A) By reducing the excess profits net income by an amount which bears the same ratio thereto as the number of months after May 31, 1940, bears to the total number of months in such taxable year; and

"(B) By adding to the amount ascertained under subparagraph (A) an amount which bears the same ratio to the excess profits net income for the last preceding taxable year as such number of months after May 31, 1940, bears to the number of months in such preceding year. The amount added under this subparagraph shall not exceed the amount of the excess profits net income for such last preceding taxable year.

"(C) If the number of months in such preceding taxable year is less than such number of months after May 31, 1940, by adding to the amount ascertained under subparagraph (B) an amount which bears the same ratio to the excess profits net income for the second preceding taxable year as the excess of such number of months after May 31, 1940, over the number of months in such preceding taxable year bears to the number of months in such second preceding taxable year."

(c) Section 713(c) of the Internal Revenue Code is amended by striking out "(c)" and inserting in lieu thereof "(g)".

(d) Section 743(a) of the Internal Revenue Code is amended by striking out "section 713(c)" and inserting in lieu thereof "section 713(g)".

SEC. 5. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

Section 721 of the Internal Revenue Code is amended to read as follows:

"SEC. 721. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

"(a) DEFINITIONS.—For the purposes of this section—

"(1) ABNORMAL INCOME.—The term 'abnormal income' means income of any class includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 125 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

"(2) SEPARATE CLASSES OF INCOME.—Each of the following subparagraphs shall be held to describe a separate class of income:

"(A) Income arising out of of a claim, award, judgment, or decree, or interest on any of the foregoing; or

"(B) Income constituting an amount payable under a contract the performance of which required more than 12 months; or

"(C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; or

"(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's accounting period or method of accounting; or

"(E) In the case of a lessor of real property, income included in gross income for the taxable year by reason of the termination of the lease; or

"(F) Income consisting of dividends on stock of foreign corporations, except foreign personal holding companies.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (F), inclusive, shall be subject to regulations prescribed by the Commissioner with the approval of the Secretary.

"(3) NET ABNORMAL INCOME.—The term 'net abnormal income' means the amount of the abnormal income less, under regulations prescribed by the Commissioner with the approval of the Secretary, (A) 125 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount

of any direct costs or expenses, deductible in determining the normal-tax net income of the taxable year, through the expenditure of which such abnormal income was in whole or in part derived as the excess of the amount of such abnormal income over 125 per centum of such average amount bears to the amount of such abnormal income.

"(b) AMOUNT ATTRIBUTABLE TO OTHER YEARS.—The amount of the net abnormal ıcome that is attributable to any previous or future taxable year or years shall e determined under regulations prescribed by the Commissioner with the aproval of the Secretary. In the case of amounts otherwise attributable to future ıxable years, if the taxpayer either transfers substantially all its properties or istributes any property in complete liquidation, then there shall be attributable) the first taxable year in which such transfer or distribution occurs (or if ıch year is previous to the taxable year in which the abnormal income is inludible in gross income, to such latter taxable year) all amounts so attributable) future taxable years not included in the gross income of a previous taxable year.

"(c) COMPUTATION OF TAX FOR CURRENT TAXABLE YEAR.—The tax under this ubchapter for the taxable year, in which the whole of such abnormal income ould without regard to this section be includible, shall not exceed the sum of:

"(1) The tax under this subchapter for such taxable year computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable year, and

"(2) The aggregate of the increase in the tax under this subchapter which would have resulted for each previous taxable year to which any portion of such net abnormal income is attributable, computed as if an amount equal to such portion had been included in the gross income for such previous taxable year.

"(d) COMPUTATION OF TAX FOR FUTURE TAXABLE YEAR.—The amount of the et abnormal income attributable to any future taxable year shall, for the purposes of this subchapter, be included in the gross income for such taxable year. he tax under this subchapter for such future taxable year shall not exceed the um of—

"(1) The tax under this subchapter for such future taxable year computed without the inclusion in excess profits net income of the portion of such net abnormal income which is attributable to such year, and

"(2) The decrease in the tax under this subchapter for the previous taxable year in which the whole of such abnormal income would without regard to this section be includible, which resulted by reason of the exclusion of the whole or a part of the abnormal income from the gross income for such previous taxable year; but the amount of such decrease shall be diminished by the aggregate of the increases in the tax under this subchapter which have resulted for the taxable years intervening between such previous taxable year and such future taxable year because of the inclusion in the gross income of the portions of such net abnormal income attributable to such intervening years."

SEC. 6. ABNORMAL BASE PERIOD EARNINGS.

Section 722 of the Internal Revenue Code is amended to read as follows:

SEC. 722. ADJUSTMENT OF ABNORMAL BASE PERIOD NET INCOME.

"(a) GENERAL RULE.—In the case of a taxpayer whose first taxable year under his subchapter begins in 1940, if the taxpayer establishes—

"(1) that the character of the business engaged in by the taxpayer as of January 1, 1940, is different from the character of the business engaged in during one or more of the taxable years in its base period (as defined in section 713(b)(1)); or

"(2) that in one or more of the taxable years in such base period normal production, output, or operation was interrupted or diminished because of the occurrence of events abnormal in the case of such taxpayer; and

"(3) the amount that would have been its average base period net income—

"(A) if the character of the business as of January 1, 1940, had been the same during each of the taxable years of such base period; and

"(B) if none of the abnormal events referred to in paragraph (2) had occurred; and

"(C) if in each of such taxable years none of the items of gross income had been abnormally large, and none of the items of deductions had been abnormally small; and

"(4) that the amount established under paragraph (3) is greater than the average base period net income computed under section 713(d) or section 742, as the case may be,

then the amount established under paragraph (3) shall be considered as the average base period net income of the taxpayer for the purposes of this subchapter.

"(b) RULES FOR APPLICATION OF SUBSECTION (a).—For the purposes of subsection (a)—

"(1) High prices of materials, labor, capital, or any other agent of production, low selling price of the product of the taxpayer, or low physical volume of sales owing to low demand for such product or for the output of the taxpayer, shall not be considered as abnormal.

"(2) The character of the business engaged in by the taxpayer as of January 1, 1940, shall be considered different from the character of the business engaged in during one or more of the taxable years in its base period only if—

"(A) there is a difference in the products or services furnished; or

"(B) there is a difference in the capacity for production or operation; or

"(C) there is a difference in the ratio of nonborrowed capital to total capital; or

"(D) the taxpayer was in existence during only part of its base period; or

"(E) the taxpayer acquired, before January 1, 1940, all or part of the assets of a competitor, with the result that the competition of such competitor was eliminated or diminished.

"(3) The average base period net income determined under subsection (a)(3) shall be computed in the same manner as provided in section 713(d), except paragraphs (2) and (4), but for such purposes computing excess profits net income and deficit in excess profits net income on the basis of the assumptions made in subsection (a)(3).

"(4) If subsection (a)(1), or both subsections (a)(1) and (a)(2) are applicable to any taxpayer, its average base period net income under subsection (a)(3) shall not exceed the excess profits net income (as computed for the purposes of subsection (a)(3)) for the last taxable year in such base period. For the purposes of this paragraph, if such last taxable year is of less than twelve months, the excess profits net income for such taxable year shall be placed on an annual basis by multiplying by twelve and dividing by the number of months included in such taxable year.

"(c) LIMITATION ON APPLICATION OF GENERAL RULE.—This section shall not be applicable unless—

"(1) the tax under this subchapter for the taxable year computed without reference to this section, exceeds 6 per centum of the taxpayer's normal-tax net income for such year; and

"(2) the application of this section would result in a diminution of the tax otherwise payable under this subchapter for the taxable year by more than 10 per centum thereof.

"(d) EXTENT OF REDUCTION IN TAX UNDER THIS SECTION.—The application of this section shall not reduce the tax payable under this subchapter for the taxable year below 6 per centum of the taxpayer's normal-tax net income for such year. The tax under this subchapter computed with the application of subsection (a) shall be increased by an amount equal to 10 per centum of the tax computed without reference to this section.

"(e) APPLICATION FOR RELIEF UNDER THIS SECTION.—The taxpayer shall compute its tax and file its return under this subchapter without the application of this section. The benefits of this section shall not be allowed unless the taxpayer, within six months from the date prescribed by law for the filing of its return, makes application therefor in accordance with regulations to be prescribed by the Commissioner with the approval of the Secretary, except that if the Commissioner in the case of any taxpayer with respect to the tax liability of any taxable year—

"(1) issues a preliminary notice stating a deficiency in the tax imposed by this subchapter such taxpayer may, within ninety days after the date of such notice, make such application, or

"(2) mails a notice of deficiency (A) without having previously issued a preliminary notice thereof or (B) within ninety days after the date of such preliminary notice, such taxpayer may claim the benefits of this sec-

tion in its petition to the Board or in an amended petition in accordance with the rules of the Board.

If the application is not filed within six months after the date prescribed by law for the filing of the return, the application of this section shall not reduce the tax otherwise determined under this subchapter by an amount in excess of the amount of the deficiency finally determined under this subchapter without the application of this section. If the average base period net income has been determined under subsection (a) for any taxable year, the Commissioner may, by regulations approved by the Secretary, prescribe the extent to which the limitations prescribed by this subsection may be waived for the purpose of determining the tax under this subchapter for a subsequent taxable year."

SEC. 7. CONSOLIDATED RETURNS OF INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL.

Section 730(e)(6) of the Internal Revenue Code is amended to read as follows:

"(6) Insurance companies subject to taxation under section 201 or 207."

SEC. 8. INCORPORATION OF PARTNERSHIP OR SOLE PROPRIETORSHIP.

(a) Section 740(a)(1)(C) of the Internal Revenue Code is amended by striking out "owned by such other corporation." and inserting in lieu thereof:

"owned by such other corporation, or

"(D) Substantially all the properties of a partnership in an exchange to which section 112(b)(5), or so much of section 112 (c) or (e) as refers to section 112(b)(5), or to which a corresponding provision of a prior revenue law, is or was applicable."

(b) Section 740(b)(4) of the Internal Revenue Code is amended by striking out the period at the end thereof and inserting in lieu thereof a semicolon and the following:

"or

"(5) In the case of a transaction specified in subsection (a)(1)(D), the partnership whose properties were acquired."

(c) Section 740 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsection:

"(h) SOLE PROPRIETORSHIP. — For the purposes of sections 740(a)(1)(D), 740(b)(5), and 742(g), a business owned by a sole proprietorship shall be considered a partnership."

(d) Section 742 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsection:

"(g) In the case of a partnership which is a component corporation by virtue of section 740(b)(5), the computations required by this Supplement shall be made, under rules and regulations prescribed by the Commissioner with the approval of the Secretary, as if such partnership had been a corporation. For the purpose of such computations, in making the adjustment for income taxes required by section 711(b)(1)(A), the partnership so regarded as a corporation shall be considered as having distributed all its net income as a dividend."

SEC. 9. PROCEDURAL PROVISIONS.

Part 1 of subchapter E of chapter 2 of the Internal Revenue Code is amended by inserting at the end thereof the following new section:

"SEC. 732. REVIEW OF ABNORMALITIES BY BOARD OF TAX APPEALS.

"(a) PETITION TO THE BOARD.—If a claim for refund of tax under this subchapter for any taxable year is disallowed in whole or in part by the Commissioner, and the disallowance relates to the application of section 711(b)(1) (H), (I), (J), or (K), section 721, or section 722, relating to abnormalities, the Commissioner shall send notice of such disallowance to the taxpayer by registered mail. Within ninety days after such notice is mailed (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) the taxpayer may file a petition with the Board of Tax Appeals for a redetermination of the tax under this subchapter. If such petition is so filed, such notice of disallowance shall be deemed to be a notice of deficiency for all purposes relating to the assessment and collection of taxes or the refund or credit of overpayments.

"(b) DEFICIENCY FOUND BY BOARD IN CASE OF CLAIM.—If the Board finds that there is no overpayment of tax in respect of any taxable year in respect of which the Commissioner has disallowed, in whole or in part, a claim for refund described in subsection (a) and the Board further finds that there is a deficiency for such

year, the Board shall have jurisdiction to determine the amount of such deficiency and such amount shall, when the decision of the Board becomes final, be assessed and shall be paid upon notice and demand from the collector.

"(c) FINALITY OF DETERMINATION.—If in the determination of the tax liability under this subchapter the determination of any question is necessary solely by reason of section 711(b)(1) (H), (I), (J), or (K), section 721, or section 722, the determination of such question shall not be reviewed or redetermined by any court or agency except the Board."

SEC. 10. CAPITALIZATION OF ADVERTISING, ETC., EXPENDITURES.

(a) Part 1 of subchapter E of chapter 2 of the Internal Revenue Code is amended by inserting at the end thereof the following new section:

"SEC. 733. CAPITALIZATION OF ADVERTISING, ETC., EXPENDITURES.

"(a) ELECTION TO CHARGE TO CAPITAL ACCOUNT.—For the purpose of computing the excess profits credit, a taxpayer may elect, within six months after the date prescribed by law for filing its return for its first taxable year under this subchapter, to charge to capital account so much of the deductions for taxable years in its applicable base period on account of expenditures for advertising or the promotion of good will, as, under rules and regulations prescribed by the Commissioner with the approval of the Secretary, may be regarded as capital investments. Such election must be the same for all such taxable years, and must be for the total amount of such expenditures which may be so regarded as capital investments. In computing the excess profits credit, no amount on account of such expenditures shall be charged to capital account:

"(1) For taxable years in the base period unless the election authorized in subsection (a) is exercised, or

"(2) For any taxable year prior to the beginning of the base period.

"(b) EFFECT OF ELECTION.—If the taxpayer exercises the election authorized under subsection (a)—

"(1) The net income for each taxable year in the base period shall be considered to be the net income computed with such deductions disallowed, and such deductions shall not be considered as having diminished earnings and profits. This paragraph shall be retroactively applied as if it were a part of the law applicable to each taxable year in the base period; and

"(2) The treatment of such expenditures as deductions for a taxable year in the base period shall, for the purposes of section 734(b)(2), be considered treatment which was not correct under the law applicable to such year."

(b) AMENDMENT TO CHAPTER 1.—Section 23(a) of the Internal Revenue Code is amended by adding at the end thereof a new paragraph, applicable to taxable years beginning after December 31, 1939, reading as follows:

"(3) EXPENDITURES FOR ADVERTISING AND GOOD WILL.—If a corporation has, for the purpose of computing its excess profits credit under chapter 2E, claimed the benefits of the election provided in section 733, no deduction shall be allowable under paragraph (1) to such corporation for expenditures for advertising or the promotion of good will which, under the rules and regulations prescribed under section 733(a), may be regarded as capital investments."

SEC. 11. ADJUSTMENT IN CASE OF INCONSISTENT POSITION.

Part 1 of subchapter E of chapter 2 of the Internal Revenue Code is amended by inserting at the end thereof the following new section:

"SEC. 734. ADJUSTMENT IN CASE OF POSITION INCONSISTENT WITH PRIOR INCOME TAX LIABILITY.

"(a) DEFINITIONS.—For the purposes of this section—

"(1) TAXPAYER.—The term 'taxpayer' means any person subject to a tax under the applicable revenue Act.

"(2) INCOME TAX.—The term 'income tax' means an income tax imposed by chapter 1 or chapter 2A of this title; Title I and Title IA of the Revenue Acts of 1938, 1936, and 1934; Title I of the Revenue Acts of 1932 and 1928; Title II of the Revenue Acts of 1926 and 1924; Title II of the Revenue Acts of 1921 and 1918; Title I of the Revenue Act of 1917; Title I of the Revenue Act of 1916; or section II of the Act of October 3, 1913; a war profits or excess profits tax imposed by Title III of the Revenue Acts of 1921 and 1918; or Title II of the Revenue Act of 1917; or an income, war

profits, or excess profits tax imposed by any of the foregoing provisions, as amended or supplemented.

"(3) PRIOR TAXABLE YEAR.—A taxable year beginning after December 31, 1939, shall not be considered a prior taxable year.

"(b) CIRCUMSTANCES OF ADJUSTMENT.—

"(1) If—

"(A) in determining at any time the tax of a taxpayer under this subchapter an item affecting the determination of the excess profits credit is treated in a manner inconsistent with the treatment accorded such item in the determination of the income-tax liability of such taxpayer or a predecessor for a prior taxable year or years, and

"(B) the treatment of such item in the prior taxable year or years consistently with the determination under this subchapter would effect an increase or decrease in the amount of the income taxes previously determined for such taxable year or years, and

"(C) on the date of such determination of the tax under this subchapter correction of the effect of the inconsistent treatment in any one or more of the prior taxable years is prevented (except for the provisions of section 3801) by the operation of any law or rule of law (other than section 3761, relating to compromises),

then the correction shall be made by an adjustment under this section. If in a subsequent determination of the tax under this subchapter for such taxable year such inconsistent treatment is not adopted, then the correction shall not be made in connection with such subsequent determination.

"(2) Such adjustment shall be made only if there is adopted in the determination a position maintained by the Commissioner (in case the net effect of the adjustment would be a decrease in the income taxes previously determined for such year or years) or by the taxpayer with respect to whom the determination is made (in case the net effect of the adjustment would be an increase in the income taxes previously determined for such year or years) which position is inconsistent with the treatment accorded such item in the prior taxable year or years which was not correct under the law applicable to such year.

"(c) METHOD AND EFFECT OF ADJUSTMENT.—(1) The adjustment authorized by subsection (b), in the amount ascertained as provided in subsection (d), if a net increase shall be added to, and if a net decrease shall be subtracted from, the tax otherwise computed under this subchapter for the taxable year with respect to which such inconsistent position is adopted.

"(2) If more than one adjustment under this section is made because more than one inconsistent position is adopted with respect to one taxable year under this subchapter, the separate adjustments, each an amount ascertained as provided in subsection (d), shall be aggregated, and the aggregate net increase or decrease shall be added to or subtracted from the tax otherwise computed under this subchapter for the taxable year with respect to which such inconsistent positions are adopted.

"(3) If all the adjustments under this section, made on account of the adoption of an inconsistent position or positions with respect to one taxable year under this subchapter, result in an aggregate net increase, the tax imposed by this subchapter shall in no case be less than the amount of such aggregate net increase.

"(d) ASCERTAINMENT OF AMOUNT OF ADJUSTMENT.—In computing the amount of an adjustment under this section there shall first be ascertained the amount of the income taxes previously determined for each of the prior taxable years for which correction is prevented. The amount of each such tax previously determined for each such taxable year shall be (1) the tax shown by the taxpayer, or by the predecessor, upon the return for such prior taxable year, increased by the amounts previously assessed (or collected without assessment) as deficiencies, and decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax; or (2) if no amount was shown as the tax by such taxpayer or such predecessor upon the return, or if no return was made by such taxpayer or such predecessor, then the amounts previously assessed (or collected without assessment) as deficiencies, but such amounts previously assessed, or collected without assessment, shall be decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax. There shall then be ascertained the increase or decrease in each such tax previously determined for each such year which results solely from the treatment of the item consistently with the treatment accorded such

item in the determination of the tax liability under this subchapter. To the increase or decrease so ascertained for each such tax for each such year there shall be added interest thereon computed as if the increase or decrease constituted a deficiency or an overpayment, as the case may be, for such prior taxable year. There shall be ascertained the difference between the aggregate of such increases, plus the interest attributable to each, and the aggregate of such decreases, plus the interest attributable to each, and the net increase or decrease so ascertained shall be the amount of the adjustment under this section with respect to the inconsistent treatment of such item."

SEC. 12. ADMISSIBLE ASSETS OF DEALERS IN SECURITIES.

(a) Section 720(a)(1)(A) of the Internal Revenue Code is amended to read as follows:

"(A) Stock in corporations except stock in a foreign personal-holding company, and except stock which is not a capital asset; and"

(b) Section 711(a)(2)(A) is amended by inserting after "companies" a period and the following: "This subparagraph shall not apply to dividends on stock which is not a capital asset".

SEC. 13. ALLOWANCE OF EXCESS PROFITS CREDIT.

Section 712 of the Internal Revenue Code is amended to read as follows:

"SEC. 712. EXCESS PROFITS CREDIT—ALLOWANCE.

"(a) DOMESTIC CORPORATIONS.—In the case of a domestic corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. In the case of all other domestic corporations the excess profits credit for any taxable year shall be an amount computed under section 714. (For allowance of excess profits credit in case of certain reorganizations of corporations, see section 741.)

"(b) FOREIGN CORPORATIONS.—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 first taxable year of which under this subchapter begins on any date in 1940, which was in existence on the day forty-eight months prior to such date and which at any time during each of the taxable years in such forty-eight months was engaged in trade or business within the United States or had an office or place of business therein, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. In the case of all other foreign corporations the excess profits credit for any taxable year shall be an amount computed under section 714.

"(c) EFFECT OF DISCLAIMER OF CREDIT.—If the taxpayer states in its return for the taxable year under this subchapter that it disclaims the use of the credit computed under section 713 or the use of the credit computed under section 714, the credit so disclaimed shall not, for the purposes of the internal revenue laws, be applicable to the computation of the tax under this subchapter for such taxable year."

SEC. 14. EXCESS PROFITS CREDIT OF ACQUIRING CORPORATIONS.

Section 741 of the Internal Revenue Code is amended to read as follows:

"SEC. 741. ALLOWANCE OF EXCESS PROFITS CREDIT.

"(a) ALLOWANCE.—In the case of a taxpayer which is an acquiring corporation which was in existence on the date of the beginning of its base period, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed.

"(b) EFFECT OF DISCLAIMER OF CREDIT.—If the taxpayer states in its return for the taxable year under this subchapter that it disclaims the use of the credit computed under section 713 or the use of the credit computed under section 714, the credit so disclaimed shall not, for the purposes of the internal revenue laws, be applicable to the computation of the tax under this subchapter for such taxable year."

SEC. 15. AVERAGE BASE PERIOD NET INCOME OF ACQUIRING CORPORATIONS.

So much of section 742 of the Internal Revenue Code as follows the section heading and precedes the beginning of subsection (a) is amended to read as follows:

"In the case of a taxpayer which is an acquiring corporation the excess profits credit of which is allowed under section 741, its average base period net income (for the purpose of the credit computed under section 713) if the taxpayer was actually in existence before January 1, 1940, shall, at the election of the taxpayer made in its return for the taxable year, be computed as folllows, and if the taxpayer was not actually in existence before such date, shall be computed as follows, in lieu of the method provided in section 713:".

SEC. 16. COMPUTATION OF CREDITS ON RETURNS.

Section 729(b) of the Internal Revenue Code is amended by striking out "(b) RETURNS.—" and inserting in lieu thereof the following:

"(b) RETURNS.—

"(1) COMPUTATION OF EXCESS PROFITS CREDITS.—In the case of a taxpayer which under section 712 or section 741 is entitled to have the excess profits credit computed under section 713 or section 714, whichever results in the lesser tax under this subchapter, the return under this subchapter for any taxable year shall contain computations of two tentative taxes, one with the credit computed under section 713 and one with the credit computed under section 714; and the return shall contain all information which the Commissioner, by regulations prescribed by him with the approval of the Secretary, may prescribe as necessary for such computations. If the taxpayer states in such return that it disclaims the use of one of such credits in the computation of the tax under this subchapter for the taxable year, the computation and information based on such credit may be omitted from the return.

"(2) NO RETURN REQUIRED.—".

SEC. 17. EFFECTIVE DATE.

The amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940.

Approved, March 7, 1941.

1941–7–10602

H. J. RES. 80. PUBLIC LAW 3, SEVENTY-SEVENTH CONGRESS [CHAPTER 3, FIRST SESSION].

Joint Resolution to amend section 124 of the Internal Revenue Code by extending the time for certification of national-defense facilities and contracts for amortization purposes.

Resolved by the Senate and House of Representatives of the United States of America in Congress assembled, That section 124(f)(1) of the Internal Revenue Code is amended by striking out ", within the time specified in paragraph (3) of this subsection, and ".

SEC. 2. Section 124(f)(3) of the Internal Revenue Code is amended to read as follows:

"The certificate provided for in paragraph (1) shall have no effect unless an application therefor is filed before the expiration of sixty days after the beginning of such construction, reconstruction, erection, or installation or the date of such acquisition, or before February 6, 1941, whichever is later: *Provided*, That in no event and notwithstanding any of the other provisions of this section, no amortization deduction shall be allowed in respect of any emergency facility for any taxable year unless a certificate in respect thereof under paragraph (1) of this subsection shall

have been made prior to the making of the election, pursuant to subsection (b) and (d)(4) of this section, to take the amortization deduction and begin the sixty-month period in or with such taxable year, or before February 6, 1941, whichever is later."

SEC. 3. Section 124(i) of the Internal Revenue Code is amended—

(a) By striking out from the first sentence thereof ", before the expiration of ninety days after the making of such contract or one hundred and twenty days after the date of the enactment of the Second Revenue Act of 1940, whichever of such periods expires the later,";

(b) By striking out from the second sentence thereof ", before the expiration of ninety days after the making of a contract or one hundred and twenty days after the date of the enactment of the Second Revenue Act of 1940, whicever of such periods expires the later,"; and

(c) By adding after the second sentence thereof a new sentence to read as follows: "The certificates provided for under this subsection shall have no effect unless an application therefor is filed before the expiration of sixty days after the making of such contract, or before February 6, 1941, whichever is later."

SEC. 4. The amendments made by this joint resolution to section 124 of the Internal Revenue Code shall be applicable as if they were a part of such section on the date of the enactment of the Second Revenue Act of 1940.

Approved, January 31, 1941.

1941–10–10627

H. R. 2959. PUBLIC LAW 7, SEVENTY-SEVENTH CONGRESS [CHAPTER 7, FIRST SESSION].

An act to increase the debt limit of the United States, to provide for the Federal taxation of future issues of obligations of the United States and its instrumentalities, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the Public Debt Act of 1941.

SEC. 2. (a) Section 21 of the Second Liberty Bond Act, as amended, is further amended to read as follows:

"SEC. 21. The face amount of obligations issued under the authority of this Act shall not exceed in the aggregate $65,000,000,000 outstanding at any one time."

(b) The authority granted in the following provisions of law to issue obligations is terminated:

(1) Section 32 of the Act entitled "An Act to provide ways and means to meet war expenditures, and for other purposes", approved June 13, 1898, as amended (U. S. C., 1934 edition, title 31, section 756) (authorizing the issue of $300,000,000 certificates of indebtedness);

(2) Section 6 of the First Liberty Bond Act, as amended (U. S. C. 1934 edition, title 31, section 755) (authorizing the issue of $2,000,000,000 certificates of indebtedness); and

(3) Section 6 of the Second Liberty Bond Act, as amended (U. S. C., 1934 edition. title 31, section 757) (authorizing the issue of $4,000,000,000 of war savings certificates).

(c) Section 301 of title III of the Revenue Act of 1940 (54 Stat. 526) (creating a special fund for the retirement of defense obligations) is repealed.

SEC. 3. Section 22 of the Second Liberty Bond Act, as amended (U. S. C., title 31, section 757c), is amended to read as follows:

"SEC. 22. (a) The Secretary of the Treasury, with the approval of the President, is authorized to issue, from time to time, through the Postal Service or otherwise, United States savings bonds and United States Treasury savings certificates, the proceeds of which shall be available to meet any public expenditures authorized by law, and to retire any outstanding obligations of the United States bearing interest or issued on a discount basis. The various issues and series of the savings bonds and the savings certificates shall be in such forms, shall be offered in such amounts, subject to the limitation imposed by section 21 of this Act, as amended, and shall be issued in such manner and subject to such terms and conditions consistent with subsections (b), (c), and (d) hereof, and including any restrictions on their transfer, as the Secretary of the Treasury may from time to time prescribe.

"(b) Savings bonds and savings certificates may be issued on an interest-bearing basis, on a discount basis, or on a combination interest-bearing and discount basis and shall mature, in the case of bonds, not more than twenty years, and in the case of certificates, not more than ten years, from the date as of which issued. Such bonds and certificates may be sold at such price or prices, and redeemed before maturity upon such terms and conditions as the Secretary of the Treasury may prescribe: *Provided*, That the interest rate on, and the issue price of, savings bonds and savings certificates and the terms upon which they may be redeemed shall be such as to afford an investment yield not in excess of 3 per centum per annum, compounded semiannually. The denominations of savings bonds and of savings certificates shall be such as the Secretary of the Treasury may from time to time determine and shall be expressed in terms of their maturity values. The Secretary of the Treasury is authorized by regulation to fix the amount of savings bonds and savings certificates issued in any one year that may be held by any one person at any one time.

"(c) The Secretary of the Treasury may, under such regulations and upon such terms and conditions as he may prescribe, issue, or cause to be issued, stamps, or may provide any other means to evidence payments for or on account of the savings bonds and savings certificates authorized by this section, and he may make provision for the exchange of savings certificates for savings bonds. The limitation on the authority of the Postmaster General to prescribe the denominations of postal-savings stamps contained in the second paragraph of section 6 of the Act of June 25, 1910, as amended (U. S. C., title 39, section 756), is removed; and the Postmaster General is authorized, for the purposes of such section and to encourage and facilitate the accumulation of funds for the purchase of savings bonds and savings certificates, to prepare and issue postal-savings stamps in such denominations as he may prescribe.

"(d) The provisions of section 7 of this Act, as amended (relating to exemptions from taxation), shall apply to savings bonds issued before the effective date of the Public Debt Act of 1941. For purposes of taxation any increment in value represented by the difference between the price paid and the redemption value received (whether at or before maturity) for savings bonds and savings certificates shall be considered as interest. The savings bonds and the savings certificates shall not bear the circulation privilege.

"(e) The appropriation for expenses provided by section 10 of this Act and extended by the Act of June 16, 1921 (U. S. C., title 31, sections 760 and 761), shall be available for all necessary expenses under this section, and the Secretary of the Treasury is authorized to advance, from time to time, to the Postmaster General from such appropriation such sums as are shown to be required for the expenses of the Post Office Department and of the Postal Service, in connection with the handling of savings bonds, savings certificates, and stamps or other means provided to evidence payment therefor, which sums may be used for additional employees or any other expenditure, wherever or in whatever class of post office incurred, in connection with such handling.

"(f) No further original issue of bonds authorized by section 10 of the Act approved June 25, 1910 (U. S. C., title 39, section 760), shall be made after July 1, 1935.

"(g) At the request of the Secretary of the Treasury the Postmaster General, under such regulations as he may prescribe, shall require the employees of the Post Office Department and of the Postal Service to perform, without extra compensation, such fiscal agency services as may be desirable and practicable

in connection with the issue, delivery, safekeeping, redemption, or payment of the savings bonds and savings certificates, or in connection with any stamps or other means provided to evidence payments."

SEC. 4. (a) Interest upon, and gain from the sale or other disposition of, obligations issued on or after the effective date of this Act by the United States or any agency or instrumentality thereof shall not have any exemption, as such, and loss from the sale or other disposition of such obligations shall not have any special treatment, as such, under Federal tax Acts now or hereafter enacted; except that any such obligations which the United States Maritime Commission or the Federal Housing Administration has, prior to the effective date of this Act, contracted to issue at a future date, shall when issued bear such tax-exemption privileges as were, at the time of such contract, provided in the law authorizing their issuance. For the purposes of this subsection a Territory, a possession of the United States, and the District of Columbia, and any political subdivision thereof, and any agency or instrumentality of any one or more of the foregoing, shall not be considered as an agency or instrumentality of the United States.

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

SEC. 5. This Act, except sections 2 (b) and (c), shall become effective on the first day of the month following the date of its enactment.

Approved, February 19, 1941.

1941–15–10681

H. J. RES. 60. PUBLIC LAW 18, SEVENTY-SEVENTH CONGRESS [CHAPTER 21, FIRST SESSION].

Joint Resolution To Amend the Internal Revenue Code.

Resolved by the Senate and House of Representatives of the United States of America in Congress assembled, That the Internal Revenue Code, as amended, be amended as follows:

In section 27(c), insert " 1936 or " before " 1937 ".

In section 113(a)(11), insert " or the Revenue Act of 1938, 52 Stat. 508," after " 49 Stat. 1698,".

In section 113(a)(11), insert " or the Revenue Act of 1938 " at the end of the third sentence and after " the Revenue Act of 1936 " wherever it appears in the last sentence.

In section 504(a), insert " or of section 405 of the Revenue Act of 1938 " after " subsection (c) of this section ".

In section 504(a), insert " or under Title IA of the Revenue Act of 1938 " after " under this subchapter ".

In section 504(a), insert " beginning after December 31, 1937 " after " any preceding taxable year ".

In section 504(b), strike out the period at the end of the subsection and insert in lieu thereof a semicolon.

In section 504(c)(3)(A), insert before the closing mark of parenthesis the following: " or, in the case of a taxable year beginning in 1939, by the amount allowed under section 405(c) of the Revenue Act of 1938 in the computation of the tax under Title IA of such Act for a taxable year beginning prior to January 1, 1939 ".

In section 506(c)(2)(A), insert after ", or both," the following: " of this section or section 407 of the Revenue Act of 1938,".

In section 506(c)(2)(B), insert after ", or both " the following: ", of this section or section 407 of the Revenue Act of 1938,".

In section 812(c), insert " or under Title III of the Revenue Act of 1932, 47 Stat. 245," after " under chapter 4,".

In section 813(a)(2), insert " or chapter 4 " before the period at the end of the heading.

In section 813(a)(2), strike out " chapter 3 " and insert in lieu thereof " this subchapter ".

In section 813(a)(2), insert " or under Title III of the Revenue Act of 1932, 47 Stat. 245," after " under chapter 4 " where it first appears.

In section 813(a)(2), insert " or under Title III of the Revenue Act of 1932 " after " under chapter 4 " wherever it appears thereafter.

In section 813(a)(2), insert " or 860 " after " 810 " wherever it appears.

In section 813(b), insert " or 860 " after " 810 " wherever it appears.

In section 861(a)(2), insert " or under Title III of the Revenue Act of 1932, 47 Stat. 245," after " under chapter 4,".

In section 936(b), insert " or under Title III of the Revenue Act of 1932, 47 Stat. 245," after " under chapter 4 " where it first appears.

In section 936(b), insert " or under Title III of the Revenue Act of 1932 " after " under chapter 4 " wherever it appears thereafter.

In section 936(b), strike out " 813(b) " from the end of paragraph (1) and insert in lieu thereof " 813(a)(2) ".

In section 1536, strike out " 3762 " and insert in lieu thereof " 3661 ".

Amend that part of section 1805 following the paragraph defining the term " silver bullion " to read as follows:

The term 'person' means an individual, partnership, association, or corporation.

The Secretary is authorized to issue, with the approval of the President, such rules and regulations as the Secretary may deem necessary or proper to carry out the purposes of this section.

In section 2887, strike out " by " preceding " the tax paid stamp " in the next to the last sentence of the second paragraph and insert in lieu thereof " of ".

In section 2901(b), strike out " any moneys in the Treasury not otherwise appropriated " from the end of the second sentence and insert in lieu thereof " annual appropriations from the general fund of the Treasury ".

In section 3170, strike out " or " where it appears immediately before " by any law ".

SEC. 2. The sections of the Internal Revenue Code amended by this joint resolution shall have effect as if such sections, as so amended, had been enacted in the Internal Revenue Code on February 10, 1939.

Approved, March 17, 1941.

COMMITTEE REPORTS.

1941–11–10648

EXCESS-PROFITS TAX AMENDMENTS OF 1941.

[House of Representatives Report No. 146, Seventy-seventh Congress, First Session.]

[February 24, 1941.]

Mr. Doughton, from the Committee on Ways and Means, submitted the following report [to accompany H. R. 3531]:

The Committee on Ways and Means, to whom was referred the bill (H. R. 3531) to amend certain provisions of the Internal Revenue Code relating to the excess-profits tax, and for other purposes, having had the same under consideration, report it back to the House without amendment and recommend that the bill do pass.

NEED FOR THE LEGISLATION.

The Second Revenue Act of 1940, approved October 8, 1940, taxes at graduated rates reaching a maximum of 50 per cent the excess profits of corporations. This Act had two major purposes, as was stated in the report of your committee. These purposes were, first, to provide additional revenue urgently needed to help meet the costs of the national-defense program, and, second, to prevent the rearmament program from furnishing an opportunity for the creation of new war millionaires or the further substantial enrichment of already wealthy persons.

In view of these compelling motives, the provisions of that Act lay a tax upon that portion of the earnings of corporations determined to be excess profits. The tax rates provided, or even higher rates, are thoroughly justified if the income subject thereto is clearly of the type intended to be reached. At the same time, equitable considerations demand that every reasonable precaution be taken to prevent unfair application of the tax in abnormal cases. The weight of the burden imposed carries with it a commensurate need for restricting its application to the cases for which it was designed.

Sensible to these considerations, your committee and the Congress, in formulating and enacting that legislation, exercised caution both with respect to the methods provided for measuring the portion of the corporate earnings to be subjected to the tax and in alleviating the specific hardships which were disclosed. At the same time, it was observed that specific treatment designed alone for such unusual cases as could then be foreseen would not prove adequate to meet the equitable demands.

For this reason the committee of conference on the second revenue bill of 1940 adopted a provision hastily designed to take care of unforeseeable situations by providing adjustments for abnormalities of both income and capital. This provision was known to be inadequate at that time but nevertheless was inserted in the law as a token of assurance to taxpayers that further congressional action would be taken in this respect. Thus, in the statement of the managers on the part of the House on the second revenue bill of 1940 [C. B. 1940–2, 551], the following statement was made with respect to further action toward the relief of abnormalities:

"It is understood that the Treasury and members of the staff of the Joint Committee on Internal Revenue Taxation will give further study to the entire problem covered by this section and will report to the appropriate committees on the subject as soon as possible."

Pursuant to those instructions, the Treasury and the staff of the Joint Committee made further studies and have reported their findings to your committee, which findings furnish the basis for the present legislation.

SUMMARY OF PRINCIPAL FEATURES.

Experience with excess-profits taxes, both in the United States and abroad, has demonstrated conclusively that relief in abnormal cases can not be predicated on specific instances foreseeable at any time. The unusual cases that are certain to arise are so diverse in character and unpredictable that relief pro-

visions couched in other than general and flexible terms are certain to prove inadequate.

For these reasons, the present legislation attempts to provide, both by specific terms and in carefully guarded general terms, a set of flexible rules which should alleviate at least the bulk of the severe hardship cases which may arise. The success or failure of legislation of this type depends, to a considerable degree, upon its intelligent and sympathetic administration. Through its confidence in the experience and ability of the officials of the Treasury Department and the Bureau of Internal Revenue, your committee recommend the present flexible and broad legislation as the most satisfactory method of meeting the contingencies that will arise.

So that the relief afforded by the bill may be available for the entire period covered by the excess-profits tax, the provisions of this legislation are made retroactive to apply to taxable years beginning after December 31, 1939.

The bill affords relief in the following situations:

1. It relieves the hardships which may be caused by the sharply fluctuating earnings of many types of companies, the activities of which are dependent upon business cycles, by allowing unused excess-profits credits to be carried over into the two succeeding taxable years, thereby tending to level off the unusual effects due to rise and fall of income. In addition, the allowance of such an excess profits credit carry-over will be of substantial benefit to new corporations, and to old corporations undergoing a period of expansion.

2. It adds to the list of adjustments for specific items of abnormal deductions, set out in section 711(b) of the existing law, a further adjustment for abnormal deductions of any class during the years in the base period.

3. Relief is provided for corporations that experienced rapid growth during the base period. Under existing law, only the average experience during those years can be counted in determining the excess-profits credit based on income. Corporations whose facilities and production capacities were substantially increased during this period would thus be penalized as compared to corporations which had already achieved and maintained a high and constant level of production. The bill will give effect to the ratio of increase during these years. This treatment will afford a substantial advantage to these expanding companies as compared with the use of the level average now required.

4. Existing law provides for adjustments with respect to six specific classes of abnormal income received during the taxable years subject to the excess-profits tax. These specific items were allowed to be spread over the years to which they are actually attributable. Your committee feel that the relief afforded by this provision should not be limited to these specific items but should be available also with respect to any item of abnormal income as such income is defined in the bill.

5. Since the average earnings credit is based upon the amount of the taxpayer's average income during the base period, the happening of some unusual event during this period may create a grave hardship on the taxpayer. For example, the taxpayer's plant may be destroyed by fire or windstorm or its operations for any year greatly impeded by flood, strikes, or other events hampering production and greatly curtailing income for a given period. The bill would attribute to the taxpayer in such an event the earnings which it would normally have experienced had such event not occurred. Likewise, if the taxpayer can establish that the character of its business as of January 1, 1940, is different from the character of the business engaged in during one or more taxable years of the base period, the taxpayer is permitted to establish what its average base period net income would have been if the character of the business had been the same during each of the taxable years of such base period. The differences which constitute a change in the character of the business are set forth in the bill.

This general relief provision is felt by your committee to be necessary in order to protect the unanticipated cases not covered by the specific relief provisions covered by existing law and the other provisions of this bill. To be effective, the provision must be elastic and as flexible as administrative demands will allow.

Proper safeguards, however, are taken to prevent abuse. For example, the burden is upon the taxpayer to establish the abnormality of its experience during the base period. In addition, relief is not granted in situations brought on by (*a*) high prices of material, labor, capital, or any other agent of production, (*b*) low selling price of the product of the taxpayer, or (*c*) low

physical volume of sales due to low demand for the taxpayer's product. Furthermore, relief under this provision is denied unless the excess-profits tax otherwise payable exceeds 6 per cent of the taxpayer's normal-tax net income for the year and unless the relief afforded by this section would diminish the excess-profits tax otherwise payable by more than 10 per cent.

The taxpayer must first compute and pay his tax without regard to this relief provision and then must petition the Commissioner for relief by way of claim for refund.

Your committee feel that so safeguarded and restricted this relief provision, though broad and general in nature, will satisfactorily alleviate hardships due to abnormal conditions in the base period, and at the same time prevent abuses.

6. Under Supplement A of existing law, corporations resulting from certain tax-free exchanges or reorganizations during or after the base period are permitted the use of their predecessor's earning experience in the computation of their excess profits credit based on income. The bill extends this privilege to corporations growing out of partnerships or sole proprietorships in tax-free exchanges during this same period. The resulting corporation would thus be allowed to use the earnings history of the predecessor partnership or sole proprietorship, after first converting such earnings to a corporate basis.

7. Under section 10 of the bill, a taxpayer in computing its excess-profits credit may elect within six months after the date prescribed by law for filing its first excess-profits return, to charge to capital account, so much of expenditures deducted in the base period for advertising or the promotion of good will, as under rules and regulations prescribed by the Commissioner may be regarded as capital investments. This will benefit the taxpayer, whether it elects the income credit or the invested capital credit in computing its excess-profits tax. Taxpayers using the income credit will have their base period income increased by the amount of the deduction disallowed. Taxpayers using the invested capital credit will have their invested capital increased by reason of a restoration of such expenditures to their earnings and profits account. A taxpayer who elects under this section must capitalize all such expenditures not only for the base period years but also for taxable years subsequent to the base period. Since the deductions in such cases are retroactively disallowed, the taxpayer is required to pay any additional income tax, plus interest thereon, which is due by reason of the disallowance of the deduction.

DETAILED DISCUSSION OF THE PROVISIONS OF THE BILL.

SECTION 1. TITLE OF THE BILL.

This section merely sets out the title of the bill, providing that it may be cited as the "Excess Profits Tax Amendments of 1941."

SECTION 2. EXCESS-PROFITS CREDIT CARRY-OVER.

This amendment removes the restriction of the carry-over privilege to corporations with normal-tax net incomes of not more than $25,000, making it applicable to all corporations, and provides for a 2-year carry-over instead of a 1-year carry-over.

SECTION 3. ABNORMAL DEDUCTIONS IN THE BASE PERIOD.

To ascertain the excess-profits credit based on income, it is necessary to determine the excess-profits net income for the taxable years in the base period. For the purposes of computing the excess-profits net income for such years, section 711(b)(1) of the present law provides for adjustments to the normal-tax or special-class net income, with respect to a number of specific items of both income and deductions. In addition to the adjustments for the deductions specified by the present law, the amendments made by this section provide that any deduction will be disallowed for the base period if it was of a class abnormal for the taxpayer. If such deduction was of a class normal for the taxpayer, then to the extent that it exceeds 125 per cent of the average amount of the deductions of such class for the four previous taxable years, such excess will be disallowed.

The 125 per cent rule, which, in the interests of certainty, is a substitute for the "grossly disproportionate" test in existing law, is also made applicable to subsection (H) (old subsection (G)), adjusting deductions for the payment of

claims, awards, judgments, and decrees against the taxpayer, and to subsection (I) (old subsection (H)), adjusting deductions attributable to intangible drilling and development costs with respect to oil and gas wells or mines.

New subsection (K) permits the adjustments provided in new subsections (H), (I), and (J) to be made also where the taxpayer was not in existence for four previous taxable years. In such case it will use such previous taxable years during which it was in existence, plus the succeeding taxable years which began before the beginning of its second taxable year subject to the excess-profits tax, but in no case to aggregate more than four taxable years. For example, Corporation A came into existence on July 1, 1938. For the purpose of measuring abnormalities or excesses of deductions for the taxable year beginning July 1, 1938, it may use the taxable years beginning July 1, 1939, and July 1, 1940. Since the taxable year beginning July 1, 1941, would be the taxpayer's second taxable year subject to the excess-profits tax, that year may not be used. This subsection also restricts the benefits of new subsections (H), (I), and (J) by placing upon the taxpayer the burden of establishing that the abnormalities or excesses in the deductions treated by those subsections are not the consequences of an increased gross income or a decrease in the size of other deductions in the base period or of changes in the type, manner of operation, size, or condition of the business conducted by the taxpayer.

Nor will deductions of any class be disallowed for any taxable year unless they exceed the amount by which the deductions of the same class for such year exceed the deductions of such class for the taxable year for which the excess-profits tax is being computed. For example, for the taxable year in the base period, 1938, a corporation had a deduction of $200,000, although its average deduction of the same class for all of the years in the test period were only $100,000. If in 1940 it had deductions of that class totaling $100,000, for the purpose of determining its average earnings credit to be used in computing its excess-profits tax for 1940, $75,000 of the deduction in 1938 would be disallowed, thereby increasing the excess-profits credit. This would be true since to the extent that the deductions of this class in 1938 exceed 125 per cent of the average deductions of the same class during the test period, they are disallowed. If in 1941, however, this taxpayer had deductions of this class totaling $150,000, only $50,000 of the $200,000 for 1938 would be disallowed in determining the average-earnings credit for use against the excess-profits net income for 1941.

New section (G) is old subsection (I) rearranged for convenience.

SECTION 4. COMPUTATION OF AVERAGE BASE PERIOD NET INCOME.

The amendments made by this section are designed for the relief of corporations that experienced rapid growth during the base period. In determining the excess profits credit based on income the present law requires the use of the average earning experience of the corporation during the years in the base period. Trends of growth during this period are given no weight. Thus, corporations which have materially expanded in the base period and have for the last year in such period a business capacity and an income much larger than that for the first year, are restricted under existing law to the use of a level average of such years. The inequities of this treatment may be illustrated by a comparison of two corporations, both of which have average base period earnings of $250,000 and, under the present law, the same credit based on income. One of these corporations has shown substantial growth during these base period years while the other has maintained a constant level.

Tax year.	Excess profits net income.	
	Corporation A.	Corporation B.
1936	$250,000	$100,000
1937	250,000	200,000
1938	250,000	300,000
1939	250,000	400,000
Total	1,000,000	1,000,000
Average	250,000	250,000

To give these two corporations the same excess-profits credit based on income as does the existing law, operates inequitably in the case of Corporation B, whose earnings have steadily increased during the base period. A credit of $250,000 does not properly reflect its earning power as of the time the excess-profits tax became applicable.

Section 4 of the bill provides an optional method whereby the factor of growth will be taken into account in ascertaining the base period average.

The method provided for by this section is operative only where the earnings for the second half of the base period are in excess of the earnings for the first half of such period. For this purpose, the base period is divided into halves, each of an equal number of months. The aggregate of the excess-profits net income for each half is first determined. The excess of the aggregate for the second half over the aggregate for the first half is then ascertained and divided by 2. The amount so found is then added to the excess-profits net income for the second half and the sum resulting from such addition is divided by the number of months in the second half and multiplied by 12. The resulting figure will be the average base period net income (95 per cent of which is to be used in ascertaining the credit), except that the average base period net income so computed can not exceed the highest excess-profits net income for any taxable year in the base period.

An example of the operation of this section is as follows: Suppose a taxpayer reporting on the calendar-year basis has the following amounts of excess-profits net income for the base period years: 1936, $100,000; 1937, $200,000; 1938, $300,000; and 1939, $400,000. Under the present provisions its average base period net income would be $250,000. Under the proposed amendment its average base period income would be computed as follows:

Sum of excess-profits net income for second half of base period	$700,000
Sum of excess-profits net income for first half	300,000
Difference	400,000
Difference divided by 2	200,000
Second half excess-profits net income	700,000
Total of last two amounts	900,000
Total placed upon an annual basis (divided by number of months in second half of base period, 24, and multiplied by 12)	450,000
Highest excess-profits net income for any taxable year	400,000
Average base period net income	400,000

This method in the case of growing corporations will thus provide a credit which is closely related to the earnings of the second half of the base period, so that the factor of growth is thus taken into account in the computation of the credit.

The 1st of June, 1940, marks generally the beginning of the industrial expansion under the national defense program. It was because of this that the amortization allowance in the Second Revenue Act of 1940 was confined to construction and acquisition after June 10, 1940. Corporations whose last taxable years in the base period extend beyond May 31, 1940, may have greatly expanded their facilities of production and, consequently, their income after that date. In giving effect to the factor of growth during the base period, equitable demands do not indicate that growth after May 31, 1940, should not be taken into account.

For this reason, section 713(f)(7), as set out in section 4 of the bill, limits the benefits to be accorded to the growth factor to increases occurring prior to June 1, 1940. In order to achieve this result in the determination of the growth factor, the excess-profits net income for any taxable year in the base period ending after May 31, 1940, is reduced by the ratio which the number of months in such year after May 31, 1940, bears to the entire number of months in such year. To such income so reduced is then added an amount which bears the same ratio to the excess-profits net income of the preceding year as the number of months after May 31, 1940, bears to the number of months in such preceding taxable year.

For example, a corporation accounts on the basis of fiscal years beginning October 1 and ending September 30. It had an excess-profits net income of $300,000 for the year ending September 30, 1939, and $600,000 for the year

ending September 30, 1940. Both of these taxable years are in the base period but four months of the fiscal year 1940 are after May 31, 1940. As applied to this corporation, this provision would operate as follows:

Taxable year.	Period.		Number of months.	Excess-profits net income.
	Beginning—	Ending—		
1939	Oct. 1, 1938	Sept. 30, 1939	12	$400,000
1940	Oct. 1, 1939	May 31, 1940	8	600,000
	June 1, 1940	Sept. 30, 1940	4	
Under subparagraph (A) of section 713 (f) (7) the excess profits net income for 1940 is reduced by four-twelfths or one-third of $600,000, equals				200,000
Total				400,000
Under subparagraph (B) this sum is increased by four-twelfths of the excess profits net income for 1939 or one-third of $400,000, equals				133,333
Total				533,333

Thus, for the purposes of this method of computing the excess profits credit, $533,333 would become the excess profits net income for 1940 in lieu of $600,000, the actual figure for that year.

If, in the above example, the number of months in the preceding taxable year had been less than the number of months in the fiscal year 1940 after May 31, 1940, then recourse must be had to the second preceding taxable year to find the income to be attributed to the excess of such months. For example, a corporation has for its last three taxable years in the base period the following taxable periods and excess profits net incomes:

Taxable years.		Number of months.	Excess profits net income.
Beginning—	Ending—		
July 1, 1938	June 30, 1939	12	$400,000
July 1, 1939	Sept. 30, 1939	3	75,000
Oct. 1, 1939	Sept. 30, 1940	12	600,000

Instead of the treatment set out in the previous example, subparagraphs (B) and (C) prescribe the following:

Taxable years.	Period.		Number of months.	Excess profits net income
	Beginning—	Ending—		
1939, first	July 1, 1938	June 30, 1939	12	$400,000
1939, second	July 1, 1939	Sept. 30, 1939	3	75,000
1940	Oct. 1, 1939	May 31, 1940	8	600,000
	June 1, 1940	Sept. 30, 1940	4	
As in the previous example, subparagraph (A) would reduce the excess profits net income for 1940 by four-twelfths or one-third of $600,000 equals				200,000
Total				400,000
Under subparagraph (B) there would be added to the sum so obtained the entire excess profits net income for the three months constituting the second 1939 fiscal year				75,000
For the one month still not taken into account, subparagraph (C) has recourse to the first 1939 fiscal year and attributes to such month one-twelfth of $400,000 equals				33,333
Total				508,333

Thus, for the purpose of the computation under subsection (f), the corporation would have an excess profits net income for its fiscal year 1940, the last year in its base period, of $508,333 instead of the actual amount of $600,000.

Provision is made in the amendment for the manner of computation where the taxpayer, because of changes in its accounting period or for other reasons, has more or less than four taxable years, and where part of one taxable year is in the first half of the base period and the other part is in the second half. To illustrate this division of a taxable year lying partly in the first half and partly in the second, the following example is given:

Years in the base period—		Number of months.	Excess profits, net income.
Beginning—	Ending—		
Sept. 1, 1936	Aug. 31, 1937	12	$30,000
Sept. 1, 1937	Dec. 31, 1937	4	20,000
Jan. 1, 1938	Dec. 31, 1938	12	60,000
Jan. 1, 1939	Dec. 31, 1939	12	100,000
Total		40	210,000
FIRST HALF.			
The taxable year beginning Sept. 1, 1936, and ending Aug. 31, 1937		12	30,000
The taxable year beginning Sept. 1, 1937, and ending Dec. 31, 1937		4	20,000
One-third of the taxable year beginning Jan. 1, 1938, and ending Dec. 31, 1938		4	20,000
Total		20	70,000
SECOND HALF.			
Two-thirds of the taxable year beginning Jan. 1, 1938, and ending Dec. 31, 1938		8	40,000
The taxable year beginning Jan. 1, 1939, and ending Dec. 31, 1939		12	100,000
Total		20	140,000

In making the computations under this alternative a deficit in excess-profits net income (or in the case of more than one deficit, the greatest deficit) is not counted as zero as in the case of the computation on the straight average basis.

SECTION 5. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

Section 721 of the present law provides relief with respect to certain abnormalities in income in the taxable period. These abnormalities, six in number, are specifically described. If abnormal income falling within any one of these six described classes is received by the taxpayer it is provided that such income should be allocated to the taxable years to which it is attributable and the tax for the current year may not exceed the tax for that year without the inclusion of the portions of the item attributable to prior years plus the increases in tax that would have resulted in such prior years from the addition to gross income of the portions of the item attributable to those years. It is believed advisable to extend the principle of this section to any abnormal item of income. As the types of abnormal income that may occur can not be predicted in advance, adequate relief can only be granted by thus extending the scope of this section.

The test of whether an item is abnormal is clarified to provide expressly that if the item includible in the gross income of the taxable year is in excess of 125 per cent of the average amount of the gross income of the same class for the four previous years it shall be considered abnormal. If the taxpayer was not in existence for the four previous taxable years, the test period is the period during which it was in existence. An item will also be considered abnormal if it is of a class which the taxpayer normally does not receive. The mere fact that an item includible in the gross income of the taxpayer is abnormal, or is in excess of 125 per cent of the average amount of the gross income of the same class for the test period, does not result in the exclusion of such item from excess-profits net income. It is necessary that the item be found attributable to other taxable years. Consequently, if an increase in business renders an item of income in excess of 125 per cent of the income for the test period, the increase in business will not result in such increased income being excluded from excess-profits net income.

It is provided further that if an item of gross income is found to be abnormal such item shall be reduced by 125 per cent of the average amount of the gross

income of the same class for the four or less previous taxable years constituting the test period.

Such abnormal item is further reduced by a proportionate part of the direct costs or expenses attributable thereto. The item so reduced is then allocated to the previous or future taxable years to which it is attributable. The computation of the tax follows the method presently provided for in section 721, except that a limitation is provided on the amount of tax that may be incurred where the item is attributable in whole or in part to future years. Under this limitation the tax on income attributable to future years in no case can exceed the tax that would be payable if the entire income were subject to tax in the year of receipt.

SECTION 6. ADJUSTMENT OF ABNORMAL BASE PERIOD NET INCOME.

Section 722 of the bill is designed to afford relief in the case of certain situations not covered by other sections of the bill. The relief is confined to the adjustment of the abnormal base period net income of a taxpayer electing the average earnings credit, and applies only in the case of a taxpayer whose first excess-profits tax taxable year begins in 1940.

In order to obtain any benefit under this section, the taxpayer must meet one of the following tests:

(1) The character of its business as of January 1, 1940, must have been different from the character of the business engaged in during one or more of the taxable years in its base period, or

(2) Normal production, output, or operation in one or more of the taxable years in the base period must have been interrupted or diminished because of events abnormal in the case of the taxpayer.

CHANGE IN CHARACTER OF BUSINESS.

The character of the business engaged in by the taxpayer as of January 1, 1940, is considered different from the character of the business engaged in during one or more of the taxable years in its base period only if:

(1) There is a difference in the products or services furnished. For example, if a corporation in one year of the base period was engaged in both the radio broadcasting and department store business and on January 1, 1940, was engaged only in the radio broadcasting business, the department store business having been discontinued, the corporation is deemed to have changed the character of its business. The same is true where a corporation was engaged in one of the base period years in both the wholesale and retail dry goods business and on January 1, 1940, was engaged only in the retail dry goods business.

(2) There is a difference in the capacity for production or operation. An illustration of such a difference would be where the corporation has enlarged its plant or increased its capital.

(3) There is a difference in the ratio of nonborrowed capital to total capital. A corporation which during the base period was operating largely on borrowed capital but as of January 1, 1940, was operating largely on equity capital is deemed to have such a difference.

(4) A taxpayer was in existence during only part of the base period. An example is where a corporation in 1938 reorganized into two or more corporations. The new corporations would have been in existence for only a part of the base period.

(5) The taxpayer acquired before January 1, 1940, all or a part of the assets of a competitor with the result that the competition of such competitor was eliminated or diminished. Assume that two newspapers were operating at a loss or with very little income during all or part of the base period. Prior to January 1, 1940, the first newspaper purchased the franchises or other assets of the second newspaper and as a result of this transaction the condition of the surviving paper was much more promising. A difference in the character of the business of the taxpayer has occurred.

Having established that the character of its business as of January 1, 1940, is different from the character of the business engaged in during one or more of the taxable years in its base period, the taxpayer is permitted to establish what its average base period net income would have been if the character of its business had been the same during each of the taxable years of such base period. In constructing its average base period net income, high prices of materials, labor, capital, or any other agent of production, low selling price of the product, a low physical volume of sales owing to low demand for such product, or for the

output of the taxpayer during the base period would not be considered as making the net income abnormal.

Moreover, the taxpayer in constructing its average base period net income would be required to eliminate that part of the items of gross income which were abnormally large or the deductions which were abnormally small. This net income would also have to be constructed as if the base period normal production, output, or operation had not been interrupted or diminished because of the occurrence of events abnormal in the case of such taxpayer. Such abnormal events might include a flood, a strike, or other events hampering production, output, or operation.

The amount of the average base period net income so established, if it is greater than its actual average base period net income, will be considered its average base period net income for the purposes of its excess-profits credit. In no case may the taxpayer's average base period net income, as established, exceed the excess-profits net income established for the last taxable year in such period.

Assume, for example, that a newspaper corporation, which had a fiscal year ending March 31, 1940, had acquired the franchises of a rival newspaper in December, 1939. Prior to that time, both papers had operated at a loss or a small profit. After such acquisition, the surviving newspaper showed a much larger profit for the remainder of its fiscal year ending March 31, 1940. Under this section, such a newspaper, by establishing what it would have earned in the base period if the character of its business had been the same throughout its base period, will be able to secure substantial relief. This relief will, however, be limited to the amount of its excess-profits net income established for the last year of its base period. Thus, if the corporation was able to establish that if the rival newspaper had been acquired as of April 1, 1939, it would have earned for the full fiscal year 1940 an amount which would make its excess-profits net income for that year $300,000, this would be the highest amount it could substitute for its average base period net income.

INTERRUPTION OR DIMINUTION OF NORMAL PRODUCTION OR OPERATION IN THE BASE PERIOD.

A taxpayer may secure relief under this section if its normal production, output, or operation was interrupted or diminished because of events abnormal in the case of the taxpayer. As in the case of taxpayers under the first category, high prices of materials, labor, capital, or any other agent of production, low selling price of the product of the taxpayer, or low physical volume of sales owing to low demand for such product or for the output of the taxpayer are not considered as abnormal. A common example of such an abnormality is where the business of the taxpayer has been interrupted or diminished due to a fire, flood, or strike. For example, if fire in 1935 had destroyed a taxpayer's plant so that the taxpayer's normal production in 1936 was diminished, the taxpayer would be permitted to establish what its normal income would have been if normal production had existed in 1936.

CHANGE OF CHARACTER OF BUSINESS AND INTERRUPTION OF NORMAL PRODUCTION.

A taxpayer with both a change in the character of business and an occurrence of an abnormal event interrupting its normal production, output, or operation in the base period is subject to the limitation that its average base period net income under this section can not exceed the excess-profits net income established for the last taxable year of such base period.

LIMITATION OF AMOUNT OF RELIEF.

In order to make this provision administratively workable, it is provided that it shall not be operative unless the excess-profits tax computed without reference to this section is at least 6 per cent of the taxpayer's normal-tax net income for such year, and unless the application of this relief provision would reduce the excess-profits tax by at least 10 per cent thereof. As a necessary complement to these limitations, it is also provided that any relief obtained under this section shall not reduce the excess-profits tax below 6 per cent of the taxpayer's normal-tax net income for the taxable year, and that the tax computed after the application of this relief provision shall be increased by an amount equal to 10 per cent of the difference between such tax and the tax that would have been payable without the benefit of this section.

Your committee feels that these limitations are necessary to a proper administration of this relief provision. The generality of the relief provided requires that the Bureau of Internal Revenue should not be loaded with so many petitions for relief as to make it impossible for it to examine and pass upon such requests with the requisite expedition and care. If experience should demonstrate that these limitations are too high, consideration will be given to their reduction.

ADMINISTRATIVE PROCEDURE.

It is deemed advisable in the interests of good administration, in view of the nature of the problem presented by section 722, that the taxpayer should not be permitted to apply the section in the computation of the excess-profits tax liability shown upon its return and that the taxpayer should be required to conform to reasonable restrictions with respect to the time within which it may make application for the benefits of the section. Accordingly, under the provisions of subsection (d) a taxpayer is not permitted to claim the benefits of section 722 in computing its tax upon the return. A taxpayer, in order to obtain the benefits of section 722, must make an application to the Commissioner of Internal Revenue under regulations to be prescribed by the Commissioner with the approval of the Secretary of the Treasury. Generally, this application must be made within six months from the date prescribed by law for the filing of the return. The time prescribed by law for filing the return includes the period of any extension of time for filing the return granted by the Commissioner. If the application is not made within such period, further opportunities in the following situations are afforded the taxpayer to secure the benefits of section 722. These situations are as follows:

(1) Under established practice and with a view to disposition of tax cases without litigation, the Commissioner ordinarily issues what is termed a preliminary notice of tax liability so as to afford the taxpayer an opportunity of a hearing before the formal notice of deficiency is mailed under section 272(a)(1) from which appeal lies only to the Board. Where such preliminary notice is issued to the taxpayer, the latter is given a period of 90 days from the date of such notice in which to make application to the Commissioner for the benefits of section 722. If in such case a formal notice of deficiency is not issued until after the expiration of such 90-day period and the taxpayer does not avail itself of the opportunity to make such application within such period, the taxpayer can not thereafter claim the benefits of the section.

(2) Owing to the running of the statute of limitations against the making of assessments, the Commissioner may find it necessary (*a*) to mail a formal notice of deficiency without having issued a preliminary notice of the tax or (*b*) having issued a preliminary notice, to mail a formal notice of deficiency prior to the termination of 90 days. In either (*a*) or (*b*) the taxpayer may claim the benefits of section 722 in its petition to the Board or by means of an amended petition conformable to the rules of the Board.

In cases under (1) or (2), the benefits of the section shall not reduce the tax under Chapter 2E by an amount in excess of the deficiency determined under that subchapter without the application of section 722.

If for any taxable year the average base period net income has been determined under section 722, the Commissioner is authorized by regulations approved by the Secretary to prescribe the extent to which the requirement of subsection (d), with respect to filing application for the benefits of section 722, may be waived for a subsequent taxable year.

SECTION 7. CONSOLIDATED RETURNS OF INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL.

Section 730 of the present law dealing with consolidated returns under the excess-profits tax does not permit an insurance company to join in a consolidated return with a noninsurance company. This restriction was inserted because of the special manner in which the income of insurance companies is computed under the income tax laws. It is believed, however, that the differences of computation in the case of an insurance company other than life or mutual are not so significant as to prevent such a company from filing a consolidated return with an ordinary corporation with which it is affiliated. Consequently, this section amends section 730 to permit such insurance companies, i. e., those subject to taxation under section 204, to join in consolidated returns with ordinary corporations.

SECTION 8. INCORPORATION OF PARTNERSHIP OR SOLE PROPRIETORSHIP.

Under present provisions a corporation formed as a result of the incorporation of a partnership or sole proprietorship may not use the earnings experienced by the latter in determining its excess-profits credit based upon income. It is believed that this restriction operates inequitably with respect to such corporations. Accordingly, this section amends the present provisions of the excess-profits tax to permit the earnings of the predecessor partnership or proprietorship to be reflected in the base period credit of the resulting corporation in those instances in which the assets of the partnership or proprietorship are transferred to the corporation in a tax-free exchange. The amendments in question are made to Supplement A of the excess-profits tax provisions, which deals with a comparable situation where the component taxpayer was a corporation. In these situations the computations required by Supplement A with respect to the income of the partnership or the proprietorship shall be made as if such partnership or proprietorship were a corporation, viz, the deduction on account of income taxes shall be computed in accordance with the income taxes applicable to corporations, a deduction for salaries shall be allowed, etc.

SECTION 9. REVIEW OF ABNORMALITIES BY BOARD OF TAX APPEALS.

Section 9 of the bill (adding section 732 to the Excess Profits Tax Act of 1940) extends to the Board exclusive jurisdiction to review the Commissioner's decision upon any question the determination of which is necessary solely by reason of section 711(b)(1)(H), (I), (J), or (K), section 721 or 722. For example, an item of income of $100,000, the amount of which is not in dispute, is includible in gross income for 1940 and involves a question concededly arising under section 721(a)(2)(A). The Commissioner determines that the item is attributable to 1939 and 1940 in the respective sums of $25,000 and $75,000. Such determination is made upon an issue arising solely under section 721 and, if the taxpayer contests such allocation, the determination of the Commissioner in such case is reviewable only by the Board. If, however, the Commissioner determines, for example, the amount of income derived by a taxpayer from a transaction falling within section 721(a)(2)(E), relating to amounts included in gross income for the taxable year by reason of the termination of a lease of real property, and the amount so determined is contested by the taxpayer, the question as to amount of such income is not one arising solely by reason of the abnormality provisions but independently of them and hence review of the determination as to the amount in such a case is not confined to the Board.

Likewise, review is not confined to the Board if, for example, the Commissioner determines that the taxpayer realized in 1940 income of a character which, if realized in that year, would fall within section 721(a)(2)(A) but which the taxpayer contends was realized in 1939. In such case the question whether income was so realized in 1940 may be reviewed by the courts upon appeal from the decision of the Board. Assuming in such case that it is ultimately held that the income was realized in 1940, a dispute as to the resulting question of allocation as between years of such item may not be carried beyond the Board.

Under existing law, unless a deficiency has been determined by the Commissioner, a taxpayer has no right of appeal to the Board (section 272(a)(1), I. R. C.). Thus, for example, if a refund claim were filed by a taxpayer and the Commissioner disallowed the claim in whole or in part but did not determine deficiency, no right of review of the Commissioner's action by the Board would be present. Inasmuch as the taxpayer's right to relief under certain of the relief provisions provided in this bill may only be raised by a claim for refund, it is necessary that a procedure be provided whereby the Board may obtain jurisdiction to review a decision by the Commissioner disallowing such claims. Accordingly, section 732 (added to the Excess Profits Tax Act of 1940 by section 9 of the bill) provides that the taxpayer may file a petition with the Board of Tax Appeals within 90 days after notice of such disallowance is mailed for redetermination of the excess-profits tax. If such petition is filed such notice of disallowance is deemed to constitute a notice of deficiency for the purposes of assessment and collection of any deficiencies and the credit or refund of overpayments (including the suspension of the statute of limitations with respect thereto). If such appeal is taken, then all pertinent issues bearing upon the tax liability under Chapter 2E may be raised by the taxpayer and reviewed by the Board. If the Board does not find an overassessment but finds a deficiency in such cases, such deficiency may be assessed and collected, regardless of any

statute of limitations otherwise applicable. If a claim for refund involving an issue of abnormality is disallowed in whole or in part, and the taxpayer does not wish to appeal to the Board, it still has the right to sue in the courts upon any issue raised in such claim except the issue with respect to abnormalities.

SECTION 10. CAPITALIZATION OF CERTAIN EXPENDITURES.

This section permits a taxpayer, under certain limitations, to capitalize expenditures for advertising and good will promotion made in the base period which the taxpayer had previously deducted as an expense. Such a provision will prevent hardship to taxpayers who deducted such items at a time when the effect of such deduction on their excess-profits credit could not be foreseen.

Only expenditures which, under rules and regulations prescribed by the Commissioner with the approval of the Secretary, may be determined to be in the nature of a capital investment are allowed to be capitalized. It is expected that such regulations will provide a method by which to differentiate normal advertising and good will expenditures which may properly be classified only as current expenses from those expenditures which may be considered to build up permanent business values, such as those embodied in trade-marks or trade names, and which are in effect a further investment in and a permanent asset of the taxpayer's business.

If a taxpayer makes an election under this section, its normal-tax or special-class net income for each base period taxable year in which advertising and good will expenditures were deducted shall be recomputed as if that portion of such expenditures which is permitted to be capitalized had been capitalized in such taxable year. Hence, the net income for each such year will be increased by the amount of the deduction disallowed, and in the case of a corporation electing the invested capital credit, the increase in net income will effect an increase in earnings and profits.

Since the revenue laws applicable to each taxable year are retroactively amended by this section in order to make the election here provided govern the deductibility of advertising and good will expenditures in such prior taxable years, the deductions taken are deemed to have been disallowed, and the taxpayer must pay the additional income tax which would have been due if the treatment in the prior income tax taxable year had been in accordance with the election provided for in this section, plus interest thereon. This prevents a taxpayer from obtaining the benefits of both a deduction and a capitalization with respect to the same item.

If no provision or rule of law prevents correction of the effect of disallowing such deductions, any additional income tax which would have been due if such deductions had been capitalized will be collected as a deficiency for the particular base period taxable year. If, however, correction of the effect of such treatment is barred, correction will be made by means of the adjustment provided under section 734.

A taxpayer electing under this section must capitalize all such expenditures deducted for base period taxable years which may be regarded as a capital investment. It is further provided that amounts allowed as a deduction on account of such expenditures in taxable years prior to the base period may not, under any circumstances, be capitalized.

In order to secure a treatment of expenditures for advertising and good will promotion in taxable years beginning after December 31, 1939, uniform with the treatment accorded similar expenditures in base period years, subsection (b) provides that a taxpayer which has elected to capitalize expenditures which it has shown to be properly considered capital investments, must capitalize for income and excess-profits tax purposes any similar capital expenditures in subsequent taxable years.

SECTION 11. ADJUSTMENT IN CASE OF INCONSISTENT POSITION.

Section 11 of the bill amends the Internal Revenue Code by the addition of a new section designated section 734. Section 734 provides for an equitable adjustment when a determination of the tax liability under Chapter 2E treats an item or transaction affecting such tax liability in a manner inconsistent with the treatment accorded such item or transaction in the determination of the income tax liability of the taxpayer, or a predecessor for a taxable year or years beginning prior to January 1, 1940. Adjustment is authorized only if (1) upon the date of the determination under Chapter 2E correction of the effect of the inconsistent treatment of the item or transaction is prevented

(except for the provisions of section 3801) in some one or more of such prior taxable years by the operation of a provision of law (other than the provisions of section 3761 relating to compromises) or a rule of law, e. g., statute of limitations, closing agreement, Board decision, or rule of res judicata, etc., and (2) the inconsistent position adopted in the determination is asserted and maintained by the party (either the Commissioner or the taxpayer) who would be adversely affected by an adjustment under this section.

A final determination is not a prerequisite to the application of the section. Whenever the tax liability is determined under Chapter 2E and the conditions prescribed in subsection (b) are satisfied, the adjustment is made as an essential part of the determination of such tax liability. If there are further proceedings in the case and the determination is overruled, the adjustment falls with the determination. If the determination becomes final, the adjustment likewise becomes final.

No adjustment under the section is authorized for any taxable year unless correction under the ordinary procedure applicable to the assessment and collection of deficiencies or the refund or credit of overpayments, as the case may be, for such taxable year is prevented. If, however, the item or transaction, in respect of which the inconsistent position is adopted in the determination, affected the determination of the tax liability in several of the prior taxable years, the ascertainment of the amount of the adjustment will require a recomputation with respect to each such year as to which correction of the effect of the inconsistent treatment is prevented.

Example: In December, 1934, Corporation X transferred depreciable property to Corporation Y in exchange for stock of Y having a fair market value of $100,000. At the time of the transfer the property had an adjusted basis in the hands of X Corporation of $80,000 and an estimated remaining life of 20 years. The exchange was treated as nontaxable and the gain of $20,000 realized by the X Corporation was recognized. For each of the years 1935 to 1939, inclusive, Corporation Y was allowed deductions for depreciation in the amount of $4,000, computed on a basis of $80,000, the same basis the property had in the hands of the X Corporation. In its excess-profits tax return for the taxable year 1940, Corporation Y claimed that the property should have a basis of $100,000 for invested capital purposes, and also claimed a deduction of $5,000 for depreciation for such year. This position was based upon the contention that the 1934 exchange was taxable and the gain of $20,000 should have been recognized and added to the basis of the property in the hands of the Y Corporation. Timely claims for refund based upon the allowance of additional deductions for depreciation for the taxable years 1938 and 1939 were filed. The statute of limitations prevents any adjustment either by way of refund of overpayments or assessment of deficiencies for the taxable years 1934 to 1937, inclusive. The Commissioner's determination of the excess profits tax liability for the taxable year 1940 adopted the inconsistent position asserted by Corporation Y and, accordingly, if the computation under section 734(d) discloses a net increase in the taxes previously determined for the taxable years for which correction is prevented, an adjustment is authorized under the provisions of section 734. The ascertainment of the amount of the adjustment under subsection (d) requires a revision of the tax of X Corporation previously determined for the year 1934 to reflect the recognition of gain in the amount of $20,000, and a revision of the tax of Y Corporation previously determined for the years 1935, 1936, and 1937 to reflect the allowance of an additional $1,000 depreciation deduction for each of those years. If, in any of the prior taxable years, the Y Corporation had been liable to the tax imposed on personal holding companies by Title IA of the Revenue Acts of 1934, 1936, or 1938, it would be necessary to determine the increase or decrease in such tax for each such year plus the interest attributable to each.

Any such increases would be aggregated with the increases in the Title I taxes for the prior taxable years and the decreases likewise would be aggregated with the decreases in the Title I taxes. The difference between the aggregate of the increases and the aggregate of the decreases would then be ascertained and the net increase so determined would be the amount of the adjustment under the terms of the above example. If the difference between the aggregate of the increases and the aggregate of the decreases so ascertained were a net decrease, then no adjustment under this section would be authorized, since by the terms of the example the taxpayer had maintained the inconsistent position, and the section does not permit either the taxpayer or the Commissioner to obtain a tax benefit by his own inconsistency.

The method of adjustment is prescribed in subsections (c) and (d). If the adjustment represents an increase in tax, it is added to the tax imposed by Chapter 2E; if the adjustment represents a decrease in tax, it is subtracted from the tax imposed by that chapter.

The recomputation prescribed in subsection (d) is merely the ascertainment of the amount of the increase or decrease in each income tax previously determined in each of the prior taxable years if the item or transaction in question had been treated consistently with the treatment accorded such item or transaction in the taxable year for which the determination under Chapter 2E is made. The recomputation does not admit of revision of any other items except to the extent that the treatment of items taken into account in ascertaining the tax previously determined is affected by the change in the gross or net income. If any such items are affected, as, for instance, deductions for contributions, foreign-tax credit, etc., revision should be made in conformity with such change. If only one taxable year is involved, the increase or decrease in each of the income taxes previously determined plus interest thereon, computed as if each such increase or decrease were a deficiency or an overpayment, as the case may be, for such taxable year, shall be ascertained. The net increase or net decrease in respect of such taxes and interest for such taxable year is the amount of the adjustment. If the inconsistent treatment of the item or transaction affected more than one of the prior taxable years, it is necessary to determine the increases or decreases in each of the taxes previously determined for each such year in which correction under the ordinary procedure is prevented. To the increases or decreases so ascertained in each such tax for each such year there shall be added interest thereon computed as if each increase or decrease constituted a deficiency or an overpayment, as the case may be, for such year. The difference between the sum of the increases, including the interest computed on such increases, and the sum of the decreases, including the interest computed on such decreases, shall be ascertained and the net increase or net decrease so determined is the amount of the adjustment under this section.

In computing the tax previously determined for any prior taxable year there shall be taken into account any adjustment previously made under the provisions of section 3801.

While the amount of the adjustment under this section is to be computed by determining the difference which would have resulted in the tax previously determined in the prior taxable years in which the inconsistent treatment took place, such prior taxable years are brought into the picture only for the purpose of measuring the amount of the adjustment. The amount of the adjustment so ascertained is to be added to or subtracted from, as the case may be, the excess-profits tax for the taxable year of the determination under Chapter 2E.

In any case where a determination of the tax liability under Chapter 2E results in the adoption of inconsistent positions with respect to several items, whether such inconsistent positions were maintained by the taxpayer or the Commissioner, or both, an independent determination under the provisions of this section shall be made in respect of each such item both for the purpose of determining the amount of the adjustment and whether such adjustment is authorized. The several adjustments authorized shall be aggregated for the purpose of determining the net addition to, or the net reduction in, the tax imposed by Chapter 2E. If the adjustments result in an aggregate net increase, the tax imposed by Chapter 2E shall in no case be less than the amount of such aggregate net increase.

If a determination under the provisions of Chapter 2E adopts an inconsistent position with respect to an item and results in an adjustment under this section, similar treatment of the same item for subsequent taxable years under Chapter 2E is not an inconsistency authorizing further adjustment under this section.

Inconsistent treatment within the meaning of the section may relate to the principle or rule of law applied in determining the taxable status of an item or transaction or it may relate only to the amount of the item which is to be taken into account for tax purposes. The inconsistency is to be ascertained by reference to the actual treatment of the item in the earlier year rather than to what the taxpayer or the Commissioner may have urged at that time. Moreover, the fact that the inconsistent position in the later year is based upon an authoritative judicial interpretation of the revenue

law which differs from the accepted interpretation of such law in the earlier year does not remove a case from the scope of the section.

Adjustments to income specifically authorized under the provisions of Chapter 2E in computing the excess-profits net income do not occasion an adjustment under this section, as the section permits adjustment only where the treatment in the prior taxable year was not correct under the law applicable to such year. This exception does not, however, extend to the disallowance of deductions for taxable years in the base period pursuant to an election under section 733 to capitalize expenditures made for advertising or the promotion of good will which were previously allowed as deductions. Section 733 specifically provides for an adjustment under this section if correction of the tax liability for the taxable year in which the deduction was previously allowed is otherwise prevented.

The term "predecessor" as used in this section means any taxpayer, other than a taxpayer subject to an adjustment under this section, whose tax liability in a prior taxable year in respect of a particular item affects the liability of a taxpayer under Chapter 2E with respect to such item, and whose tax liability in such prior taxable year in respect of such item would have been different if there had been no inconsistency between the determination of the liability of the taxpayer under Chapter 2E and the determination of its own liability for such prior taxable year. The term includes, among others, a member of an affiliated group as defined in section 730 or a component corporation within the meaning of section 740(b) (or, if such component corporation is a partnership, the members of such partnership).

SECTION 12. ADMISSIBLE ASSETS OF DEALERS IN SECURITIES.

For corporations using the invested capital credit dividends, except dividends (actual or constructive) on the stock of foreign personal holding companies, are excluded from the excess profits net income. Likewise, stock in corporations, except stock in a foreign personal holding company, is made an inadmissible asset by section 720(a)(1) of the present law. Corporate stocks held by dealers, not as investments for themselves but for sale to their customers, are, in reality, no different from any other article held for sale by a dealer.

Section 12 of the bill amends section 720(a)(1) of the present law so as to allow corporate stocks held by a dealer for sale to customers to be treated as admissible assets. However, dividends on stocks so treated are subjected to the excess-profits tax to the extent that they exceed the credit for dividends received provided in section 26(b) of the Internal Revenue Code. Such stocks held by dealers for investment would continue to be treated as inadmissible assets.

SECTION 13. EFFECTIVE DATE.

This section provides that the amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940, which applies to taxable years beginning after December 31, 1939.

1941–11–10649

EXCESS-PROFITS TAX AMENDMENTS OF 1941.

[Senate Report No. 75, Seventy-seventh Congress, First Session. Calendar No. 78.]

[February 27 (legislative day, February 13), 1941.]

Mr. Harrison, from the Committee on Finance, submitted the following report [to accompany H. R. 3531]:

The Committee on Finance, to whom was referred the bill (H. R. 3531) to amend certain provisions of the Internal Revenue Code relating to the excess-profits tax, and for other purposes, having had the same under consideration, report favorably thereon with certain amendments and as amended recommend that the bill do pass.

These amendments are as follows:

In lieu of section 13 of the House bill, four new sections are added. Under existing law a corporation entitled to use either the income credit or the invested capital credit is required irrevocably to choose between such credits for each taxable year. The amendments adopted by your committee relieve the taxpayer

of the hardship of having to make such an election and provide instead that the credit shall be the one resulting in the lesser tax.

It is provided, however, that if a taxpayer desires to avoid making the necessary computations under both credits, it may disclaim the application of the credit which it does not desire, and thereby relieve itself of the necessity of making the computation under such disclaimed credit.

The amendments made by your committee retain the principle embodied in section 13 of the House bill. Under that principle corporations required under existing law to compute their tax under Supplement A may, if they so elect, compute it under such supplement or under Part I as do corporations not falling under Supplement A.

For convenience, since no other changes were made in the House bill, the report of the Committee on Ways and Means, * * *, follows in its entirety. New sections 13, 14, 15, 16, added by your committee are then explained in detail. Section 13 of the House bill, setting out the effective date, becomes section 17.

[The House report referred to above (H. Rept. No. 146) is printed in full on pages 550 to 564 of this Bulletin.]

SECTIONS 13, 14, 15, AND 16. ALLOWANCE OF CREDIT.

Under existing law a domestic corporation which was in existence before January 1, 1940, is required to elect in its return between the credit based upon invested capital and the credit based upon base period income. The committee bill relieves the taxpayer of the necessity of making such an election and instead provides that the credit shall be an amount computed under either section 713 (the credit based upon base period income) or section 714 (the credit based upon invested capital), whichever amount results in the lesser tax for the taxable year for which the tax is being computed. As a consequence of the elimination of the election requirement, the bill also eliminates as unnecessary the provision that if no return is filed, only the invested capital method may be used. A similar change is made with respect to foreign corporations. Section 741 of Supplement A is likewise amended to eliminate the requirement of an election.

These sections require, in the case of a taxpayer which under section 712 or section 741 is entitled to have the excess profits credit computed under section 713 or section 714, whichever results in the lesser tax under this subchapter, that the return shall contain computations of two tentative taxes, one with the credit computed under section 713 and one with the credit computed under section 714. The return shall also contain all information which under regulations is prescribed as necessary for the computations under each credit. A return which contains only computations under one of the credits shall (except in the event of a disclaimer as hereinafter described) be regarded as no return.

It is provided, however, that a taxpayer who does not desire to make the necessary computations in its return under both credits may state in its return that it disclaims the use of whichever credit it does not desire. In that event the computation and information based on the credit so disclaimed may be omitted from the return. If such disclaimer is made, the credit so disclaimed shall not, for the purposes of the internal revenue laws (e. g., the computation of earnings and profits, the computation of the excess profits credit carry-over, etc.), be applicable to the computation of the tax for such taxable year with respect to which the disclaimer is made.

Section 15 of the committee bill retains the principle of section 13 of the House bill with respect to Supplement A corporations. Supplement A of the existing provisions of the excess-profits tax provides for a method of computation of the base period net income in the case of corporations which have experienced mergers, consolidations, or liquidations. Such method under the present law is mandatory for such corporations. The bill amends section 742 of existing law to make such method elective in the case of corporations actually in existence prior to January 1, 1940. Such corporations may compute their average base period net income under either section 713 or Supplement A. The election must be made in the taxpayer's return.

SECTION 17. EFFECTIVE DATE.

This section provides that the amendments made by this Act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940, which applies to taxable years beginning after December 31, 1939.

1941–7–10603

AMENDING SECTION 124 OF INTERNAL REVENUE CODE BY EXTENDING TIME FOR CERTIFICATION OF NATIONAL-DEFENSE FACILITIES AND CONTRACTS FOR AMORTIZATION PURPOSES.

[House of Representatives Report No. 11, Seventy-seventh Congress, First Session.]

[January 24, 1941.]

Mr. Doughton, from the Committee on Ways and Means, submitted the following report [to accompany H. J. Res. 80]:

The Committee on Ways and Means, to whom was referred the resolution (H. J. Res. 80) to amend section 124 of the Internal Revenue Code by extending the time for certification of national-defense facilities and contracts for amortization purposes, having had the same under consideration, report it back to the House without amendment and recommend that the resolution do pass.

Representatives of the War Department, the Navy Department, and the Advisory Commission to the Council of National Defense appeared before your committee and urged the speedy enactment of this legislation. They pointed out that in order properly to discharge their duties in this respect each application for certificates, a prerequisite to the amortization allowance, must be carefully investigated and that these applications were being filed in such numbers as to make it impossible for certificates to be issued for all of them before the dead lines contained in existing law.

The legislation is purely procedural in character, having to do only with extending the time within which effective certification can be made, and makes no change in the substantive provisions of existing law.

PROCEDURAL PROVISIONS OF EXISTING LAW.

Facilities.—The law now allows rapid tax amortization with respect to facilities, the construction of which has been completed, or which were acquired, after June 10, 1940; provided, however, that such construction or acquisition is certified as necessary in the interest of national defense by the Advisory Commission and either the Secretary of War or the Secretary of the Navy. Certification of the necessity for the facilities must be made before construction is begun or before the acquisition is effected, except that certificates made before February 5 are effective for construction already begun or acquisition already made. Consequently, the statute as it presently stands places a burden upon the Advisory Commission and the War and the Navy Departments to make certification before February 5 of construction begun and acquisitions already effected if the taxpayer making application for such certification is to secure its tax privilege.

Contracts.—The law presently provides that contracts between the taxpayer and the United States which reimburse the taxpayer directly or indirectly for the cost of facilities with respect to which it is seeking this tax privilege must be certified as containing provisions protecting the public interest in the use and disposition of the facilities. The law requires that such certificates shall be made within 90 days after the date of execution of the contract or before February 6, whichever date is later. Consequently, the law requires that the Advisory Commission and the War and Navy Departments certify before February 6 the adequacy of the protective terms in such contract executed before November 7, 1940, or else the taxpayer applying for such a certificate will have lost its opportunity to take the tax privilege.

The law places a similar dead-line restriction upon the issuance of certificates, to the effect that a contract does not directly or indirectly reimburse the taxpayer for the cost of facilities. Such contracts must be certified as to nonreimbursement either within 90 days after the date of execution or before February 6, 1941, whichever is later.

PROPOSED AMENDMENT.

Facilities.—It is proposed to amend subsection (f) of section 124 so that the Advisory Commission and the War and Navy Departments may effectively certify the necessity for facilities, provided the application for such a certificate

is filed before February 6, 1941, or within 60 days after acquisition or the beginning of construction, whichever is later. It is further proposed to provide, however, that such certification shall not be effective to support a taxpayer's election to take the amortization deduction unless the certificate is issued before the expiration of the due date for filing the return for the taxable year in which the taxpayer elects to begin the 60-month amortization period or before February 6, 1941, whichever is later.

Contracts.—It is proposed to amend subsection (i) of section 124 so as to provide that the Advisory Commission and the War and Navy Departments may effectively certify a contract, provided that application for such certificate is filed within 60 days after the date of execution of the contract or before February 6, 1941, whichever is later.

EXPLANATION OF THE AMENDMENTS.

Removal of the February 5 and 6 dead lines on filing applications for certificates.—The amendments with respect to the change in the dead line provided in the present statute proceed on the theory that the time limitation should be imposed, not upon certification by the Government agencies, but upon application by the taxpayer.

This is imperative in order to insure thorough and careful administration of the certification functions. Under the present law, the Advisory Commission and the War and Navy Departments are presently faced with a rush of applications just preceding the February 5 dead line. A large number of applications relating to construction already commenced and acquisitions already made are still being filed. If these applications are to be thoroughly examined and the issues presented properly resolved, the pressure for the issuance of certificates before February 6 should be removed.

Moreover, it is believed that it is unfair to a taxpayer to cause it to lose its certification because the certifying agencies are unable to perform adequately their duties within the time specified in the statute, a fact over which the taxpayer has no control.

For these reasons the amendments require the taxpayer which has begun construction of, or acquired, any facility for which it seeks a certificate to file its application for certification either before February 6, 1941, or within 60 days after the date of the beginning of construction, or acquisition of, such facility, whichever date is later. Following the same principle, applicants for contract certificates are required by the proposed amendments to file applications for such certificates within 60 days after making of the contract or before February 6, 1941, whichever date is the later. In either case the effectiveness of the certificate, if issued, will depend upon the date upon which the application is filed by the taxpayer and not upon the date on which the certificate is made.

It is not clear under the present law whether a taxpayer which elects in its return to take the amortization deduction and begin the 60-month period is entitled to such deduction if the facilities which it desires to amortize have not been certified at the time the return is filed but are certified some time after the expiration of the time for filing the return. If in such case the taxpayer is entitled to begin the amortization period at the time signified in its return, the Commissioner of Internal Revenue might be compelled to assert a deficiency against the taxpayer pending issuance of the certificate of necessity, and the taxpayer, after paying the deficiency, might then be forced to file a claim for refund after the certificate was issued. In order to relieve the Commissioner of Internal Revenue of this administrative burden, the proposed amendments contain a provision making it clear that the amortization deduction will not be allowed for any taxable year unless the required certificate of necessity has been issued prior to the expiration of the due date for filing its return for such year or before February 6, 1941, whichever is later.

It should be noted that presently the law establishes two dead-line dates, February 5 for facilities certificates and February 6 for contract certificates. This difference resulted from minor language differences in the law. There is no substantive reason for retaining this difference, and in order to avoid confusion the proposed amendments would establish a single date of February 6, 1941, applicable in all cases.

Need after February 5 for certification of facilities after construction thereof is begun or acquisition made.—The requirement in the present law that certifi-

cates be issued prior to the beginning of construction or the making of the acquisition has in some instances threatened delay in the construction and acquisition of facilities vital to national defense. This situation has been most frequently met in cases involving acquisition of tooling and other similar equipment to meet the demands of future supply orders. Expeditious handling of these future supply orders will often require that the supplier place his orders for equipment well in advance of his actual production program. At this early stage it is difficult for the supplier to prepare a definite and specific application for a necessity certificate and equally difficult for the Advisory Commission and the War or Navy Department to determine the propriety of issuing such a certificate. It is proposed, therefore, that in such cases the orderly and expeditious handling of the certification functions without delaying the procurement program will be greatly advanced by amending the law so that such acquisitions, in some cases also involving construction, can be made and preliminary steps taken before the date on which either a certificate must be made or the right to a certificate foreclosed.

It is believed that the threat of delay from this cause may be avoided by removing the requirement that certification must be made before construction is begun or acquisition is effected. Instead the amendments merely require that application for such certification must be made within 60 days after the beginning of the construction or the making of an acquisition.

The proposed amendment has a further advantage in that it will permit the taxpayer to describe more definitely than it is possible for him to do under the present law facilities which he is proposing to construct or acquire and which he avers are necessary for national defense.

RETROACTIVE EFFECT OF THE PROPOSED BILL.

Section 4 of the resolution would require that the amendment of section 124 contained in the resolution have the same force and effect as if it were provided in the present law. By this means it will be possible to preserve to the taxpayer his same privileges with respect to selecting the year in which he is to deduct his amortization as if he had secured his certificate in accordance with the procedure provided in the present law.

1941–7–10604

AMENDING SECTION 124 OF INTERNAL REVENUE CODE BY EXTENDING TIME FOR CERTIFICATION OF NATIONAL-DEFENSE FACILITIES AND CONTRACTS FOR AMORTIZATION PURPOSES.

[Senate Report No. 6, Seventy-seventh Congress, First Session. Calendar No. 5.]

[January 27, 1941.]

Mr. Herring, from the Committee on Finance, submitted the following report [to accompany H. J. Res. 80]:

The Committee on Finance, to whom was referred the joint resolution (H. J. Res. 80) to amend section 124 of the Internal Revenue Code by extending the time for certification of national-defense facilities and contracts for amortization purposes, having considered the same, report it favorably without amendment and recommend that the joint resolution do pass.

The purpose of House Joint Resolution 80 is fully explained in the report of the House Committee on Ways and Means accompanying the joint resolution, which is attached hereto and made a part of this report.

[The House report referred to, House Report No. 11, Seventy-seventh Congress, first session, is published on pages 566 to 568 of this Bulletin.]

1941-10-10628

INCREASING THE DEBT LIMIT OF THE UNITED STATES AND PROVIDING FOR FEDERAL TAXATION OF FUTURE ISSUES OF OBLIGATIONS OF THE UNITED STATES AND ITS INSTRUMENTALITIES.

[House of Representatives Report No. 20, Seventy-seventh Congress, First Session.]

[February 3, 1941.]

Mr. Doughton, from the Committee on Ways and Means, submitted the following report [to accompany H. R. 2959]:

The Committee on Ways and Means, to whom was referred the bill (H. R. 2959) to increase the debt limit of the United States, provide for the Federal taxation of future issues of obligations of the United States and its instrumentalities, and for other purposes, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

The bill is designed (*a*) to increase the public debt limit; (*b*) to give the Treasury greater and more flexible control over savings bonds as a medium of financing; (*c*) to substitute a new obligation called Treasury savings certificates for the war-savings certificates now authorized by law; and (*d*) to remove all privileges of exemption from Federal taxation from Federal obligations issued in the future.

NEED FOR THE LEGISLATION.

Our contemplated national-defense program has now increased until it aggregates $28,500,000,000 in appropriations, contract authorizations, and recommendations, according to the 1942 Budget. The estimated expenditure program included in this Budget will result in combined deficits for the fiscal years 1941 and 1942 amounting to more than $15,000,000,000. The balance of the borrowing authority of the Treasury Department on January 1, 1941, was $886,000,000 under the general limitation and $2,764,000,000 under the national-defense limitation contained in the First Revenue Act of 1940, which provided for the issuance of not more than $4,000,000,000 short-term defense obligations. These combined balances provide the Treasury with borrowing authority sufficient only for the next four months and, even in that period, the Treasury Department would be greatly restricted in its financing operations.

The Secretary of the Treasury appeared before your committee and testified that it would not be advisable to undertake the financing of the enlarged national-defense program through the issuance of short-term securities. He also deemed it unwise to require defense securities to be retired from earmarked revenues within a specified period, as contemplated in the First Revenue Act of 1940.

Mr. Morgenthau pointed out that short-term securities are for the most part purchased by commercial banks, thereby causing a further increase in deposits. In order to avoid, as far as possible, encouraging such a result, he recommended that the Treasury be permitted to issue obligations more attractive to permanent investors outside of the banking system.

GENERAL EXPLANATION OF THE BILL.

The bill amends the Second Liberty Bond Act, as amended, so as to limit the face amount of public-debt obligations issued under the authority of that Act to an amount not to exceed in the aggregate $65,000,000,000 outstanding at any one time. It is believed that this increased limitation will amply cover the Treasury's present anticipated financing requirements for the current and ensuing fiscal year. The bill terminates the authority to issue $4,000,000,000 of short-term defense obligations provided in the First Revenue Act of 1940 and certain obsolete authority to issue debt obligations of a character which the Treasury does not need and which, therefore, should be eliminated from the statute books. The future borrowing authority fixed by this bill will be all-inclusive.

In view of the enlarged financing program facing the Treasury Department, it is desirable that it have greater flexibility in the types of securities which may be offered to meet the requirements of various classes of investors.

Therefore, this bill further amends the Second Liberty Bond Act so as to broaden the authority under which United States savings bonds are issued and to provide for a new class of security to be called Treasury savings certificates. The statutory limit on the term for which savings bonds may be issued would continue to be 20 years, as at the present, while a limitation of 10 years would be placed on the Treasury savings certificates. It would also provide that both classes of securities may be issued on an interest-bearing basis, on a discount basis, or on a combination interest-bearing and discount basis and that the Secretary of the Treasury may fix by regulation the amount of savings bonds and savings certificates which may be held by any one person at any one time.

In addition, the Treasury would be authorized to issue stamps or provide other means to evidence payments for savings bonds and savings certificates, and to provide for the exchange of savings certificates for savings bonds. This would permit the Treasury to carry on a program encouraging more popular participation in defense financing and to offer securities of a character which should facilitate and promote thrift and savings.

In so far as Federal taxation of Federal securities is concerned, the bill removes the tax-exemption privilege by providing that all obligations issued in the future by the United States and its agencies and instrumentalities (except Territories, possessions, and the District of Columbia) shall be subject to Federal taxes to the same extent as private obligations.

The bill makes no change in existing law with respect to the taxation of Federal securities by the States and their political subdivisions nor does it affect in any way the taxable status of obligations of States, municipalities, and other local governmental agencies.

It will remove, however, all privileges of exemption from Federal taxation not only from direct obligations of the United States but also from all obligations issued by the various Federal corporations, instrumentalities, and agencies. While the elimination of the Federal tax-exemption privilege will apply to all future issues of Federal obligations, securities issued solely to replace those issued prior to the effective date of the Act which have been lost or destroyed, or securities issued in different denominations in exchange for securities issued prior to such effective date and bearing the same maturity and interest rate, will have the same tax-exemption status as the securities replaced or exchanged. On the other hand, any refunding obligations issued subsequent to the effective date of the Act would be fully subjected to Federal taxes under the provisions of the bill.

Your committee feel that it is particularly appropriate that this step should be taken in connection with the financing of the national-defense program. All should be called upon to share in the enormous task of supplying the revenue necessary to finance this program. It becomes urgent therefore, from an equitable point of view, that no subscribers to any given class of securities should receive preferential treatment. This result is impossible if some securities are issued with tax-exemption privileges which are worth little or nothing to the poorer classes of subscribers, but which are worth a great deal to those in the higher income brackets. Preferential treatment to this latter class is incompatible with democratic methods of financing the defense program and should be removed.

Your committee strongly recommend prompt consideration and action on this important legislation. Two factors particularly support this recommendation: (1) As the Treasury is rapidly approaching the limit of its borrowing authority, it is becoming daily more restricted in the flexibility of its financing operations and flexibility is essential to the successful operation of the vast financial program necessary to arm and defend the United States and guarantee its national security in the world of to-day; (2) as large amounts of long-term Federal obligations mature on March 15, 1941, it is important that the present legislation be enacted before that date.

DETAILED ANALYSIS OF THE BILL.

Section 1: This section merely gives the bill a short title.

Section 2: This section amends section 21 of the Second Liberty Bond Act, as amended, and also terminates certain authority to issue obligations.

In its present form section 21 is made up of subsections (a) and (b). Subsection (a) limits to $45,000,000,000 face value the amount of bonds, certificates of indebtedness, Treasury bills, and notes issued under the Second Liberty

Bond Act, as amended, or under section 6 of the First Liberty Bond Act, as amended, which may be outstanding at one time. Subsection (b), which was added by section 302 of the Revenue Act of 1940, authorizes the issuance, under the Second Liberty Bond Act, as amended, of not to exceed $4,000,000,000 of "National-defense series" obligations.

The combined limitation of $49,000,000,000 established by section 21 is not all-inclusive. At the present time direct obligations may be issued under the following provisions of law:

(1) Sections 1 (bonds), 5 (certificates of indebtedness and bills), 6 (war-savings certificates), 18 (notes), 21(b) (certificates of indebtedness, bills, and notes), and 22 (savings bonds) of the Second Liberty Bond Act, as amended.

(2) Section 6 of the First Liberty Bond Act, as amended (certificates of indebtedness).

(3) Section 32 of the Act of June 13, 1898 (certificates of indebtedness).

The $49,000,000,000 limit applies to all of the above except war-savings certificates issued under section 6 of the Second Liberty Bond Act, as amended (of which $4,000,000,000 may be issued), and certificates of indebtedness issued under the Act of 1898 (of which $300,000,000 may be issued).

Under section 21, as amended by section 2(a) of this bill, the limit on the amount of obligations which may be outstanding under the Second Liberty Bond Act, as amended, is fixed at $65,000,000,000, the authority to issue national-defense series obligations is repealed, and the reference to section 6 of the First Liberty Bond Act, as amended, is deleted.

Section 2(b)(1) would terminate existing authority to issue $300,000,000 of certificates of indebtedness which are now outside the $49,000,000,000 debt limit. Section 2(b)(2) would terminate existing authority to issue $2,000,000,000 of certificates of indebtedness which are subject to the present debt limit but which would not be subject to the new $65,000,000,000 limit under section 2(a) of this bill. Section 2(b)(3) would terminate existing authority to issue $4,000,000,000 war-savings certificates which are now outside the $49,000,000,000 limit.

The net result of sections 2(a) and 2(b) of this bill will be to consolidate under the Second Liberty Bond Act, as amended, all authority of the Treasury to issue direct obligations, and thus make the $65,000,000,000 limitation the actual limit of the amount of such obligations which may be outstanding at one time.

Section 2(c) would eliminate the special fund now required for the retirement of national-defense series obligations by repealing the provision of law under which it was established.

Section 3: This section amends section 22 of the Second Liberty Bond Act, as amended (the law under which savings bonds are issued) in the following particulars:

(1) It authorizes issuance, under the laws which govern the issuance of savings bonds, of a new type of obligation called United States Treasury savings certificates as a substitute for the war savings certificates now authorized by section 6 of the Second Liberty Bond Act, as amended (such authority is terminated by section 2 of the bill). While the Secretary of the Treasury would have authority under the bill to differentiate between the terms of bonds and certificates in other respects, the only difference between the two obligations imposed by law would be in the maturity dates. In the case of bonds the maturity date could not exceed 20 years, while in the case of certificates it could not exceed 10 years.

(2) Savings bonds must now be issued on a discount basis. Under this amendment savings bonds as well as savings certificates could be issued on either a discount or an interest-bearing basis or on a combination interest-bearing and discount basis.

(3) Under existing law the denominations of savings bonds may not be less than $25. Under this amendment both bonds and certificates could be issued in such denominations as the Secretary of the Treasury may fix.

(4) Under existing law no person may hold more than $10,000 maturity value of saving bonds issued in any one calendar year. Under this amendment the Secretary of the Treasury could from time to time by regulation increase or lower that limit with respect to either bonds or certificates.

(5) It authorizes the issuance of stamps to evidence partial payment on savings bonds and certificates and the exchange of certificates for bonds.

(6) It makes the indefinite appropriation "Expenses of loans, Act of September 24, 1917, as amended and extended" available to cover expenses incident

to the issuance of savings certificates. Such appropriation is now available to cover the expenses of issuing savings bonds.

Section 4: This section would, in effect, make interest upon, and gain from, the sale or other disposition of all obligations issued in the future by the United States and its agencies and instrumentalities (except Territories, possessions, and the District of Columbia and any political subdivision thereof, and any agency or instrumentality of any one or more of the foregoing) subject to taxation by the Federal Government to the same extent as like obligations of private issuers. Obligations issued in the future by the Maritime Commission and the Federal Housing Administration under commitments embodied in guaranty contracts entered into prior to the taking effect of this section would be treated as outstanding obligations. The phrase "the United States or any agency or instrumentality thereof" is used in the broadest possible sense, so as effectively to eliminate for the future (with the specific exceptions noted above) whatever exemptions from Federal taxation may have been accorded to any obligations by any Act of Congress. This section does not affect in any way the taxable status of obligations of States, municipalities, and other local governmental agencies.

Section 5: This section merely provides that the bill, except sections 2 (b) and (c), is to become effective on the 1st day of the month following the date of enactment of the bill. Section 2 (b) and (c) are to become effective immediately.

* * * * * * *

For the information of the House of Representatives, there are set forth below the provisions of law referred to in section 2(b) of the bill.

ACT OF JUNE 13, 1898.

SEC. 32 [as amended]. That the Secretary of the Treasury is authorized to borrow, from time to time, at a rate of interest not exceeding three per centum per annum, such sum or sums as, in his judgment, may be necessary to meet public expenditures, and to issue therefor certificates of indebtedness in such form and in such denominations as he may prescribe; and each certificate so issued shall be payable, with the interest accrued thereon, at such time, not exceeding one year from the date of its issue, as the Secretary of the Treasury may prescribe: *Provided*, That the sum of such certificates outstanding shall at no time exceed $300,000,000, and the provisions of existing law respecting counterfeiting and other fraudulent practices are hereby extended to the bonds and certificates of indebtedness authorized by this Act.

FIRST LIBERTY BOND ACT.

SEC. 6. That in addition to the bonds authorized by sections 1 and 4 of this Act, the Secretary of the Treasury is authorized to borrow from time to time, on the credit of the United States, for the purposes of this Act and to meet public expenditures authorized by law, such sum or sums as, in his judgment, may be necessary, and to issue therefor certificates of indebtedness at not less than par in such form and subject to such terms and conditions and at such rate of interest, not exceeding 3½ per centum per annum, as he may prescribe; and each certificate so issued shall be payable, with the interest accrued thereon, at such time, not exceeding one year from the date of its issue, as the Secretary of the Treasury may prescribe. Certificates of indebtedness herein authorized shall not bear the circulation privilege, and the sum of such certificates outstanding shall at no time exceed in the aggregate $2,000,000,000, and such certificates shall be exempt, both as to principal and interest, from all taxation, except estate or inheritance taxes, imposed by authority of the United States, or its possessions, or by any State or local taxing authority.

SECOND LIBERTY BOND ACT.

SEC. 6. [as amended]. That in addition to the bonds authorized by section 1 of this Act and the certificates of indebtedness authorized by section 5 of this Act, the Secretary of the Treasury is authorized to borrow from time to time, on the credit of the United States, for the purposes of this Act and to meet public expenditures authorized by law, such sum or sums as in his judgment may be necessary, and to issue therefor, at such price or prices and upon such terms and conditions as he may determine, war-savings certificates of the United

States on which interest to maturity may be discounted in advance at such rate or rates and computed in such manner as he may prescribe. Such war-savings certificates shall be in such form or forms and subject to such terms and conditions, and may have such provisions for payment thereof before maturity, as the Secretary of the Treasury may prescribe. Each war-saving certificate so issued shall be payable at such time, not exceeding five years from the date of its issue, and may be redeemable before maturity, upon such terms and conditions as the Secretary of the Treasury may prescribe. The sum of such war-savings certificates outstanding shall not at any one time exceed in the aggregate $4,000,000,000. It shall not be lawful for any one person at any one time to hold war-savings certificates of any one series to an aggregate amount exceeding $5,000. The Secretary of the Treasury may, under such regulations and upon such terms and conditions as he may prescribe, issue, or cause to be issued, stamps to evidence payments for or on account of such certificates.

1941–10–10629

INCREASING THE DEBT LIMIT OF THE UNITED STATES AND PROVIDING FOR FEDERAL TAXATION OF FUTURE ISSUES OF OBLIGATIONS OF THE UNITED STATES AND ITS INSTRUMENTALITIES.

[Senate Report No. 41, Seventy-seventh Congress, First Session. Calendar No. 46.]

[February 13, 1941.]

Mr. Brown, from the Committee on Finance, submitted the following report [to accompany H. R. 2959]:

The Committee on Finance, to whom was referred the bill (H. R. 2959) to increase the debt limit of the United States, provide for the Federal taxation of future issues of obligations of the United States and its instrumentalities, and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill, as amended, do pass.

The bill is designed (*a*) to increase the public debt limit and eliminate the present partitions in that limit; (*b*) to give the Treasury greater and more flexible control over savings bonds as a medium of financing; (*c*) to authorize issuance of a new obligation called Treasury savings certificates in place of the war-savings certificates now authorized by law; and (*d*) to subject all Federal obligations issued in the future to Federal taxation by removing all privileges of exemption from such taxation which they now enjoy.

The amendments recommended by your committee are as follows:

On page 4, line 13, immediately following the period at the end of subsection (c), add the following:

"The limitation on the authority of the Postmaster General to prescribe the denominations of postal-savings stamps contained in the second paragraph of section 6 of the Act of June 25, 1910, as amended (U. S. C., title 39, section 756), is removed; and the Postmaster General is authorized, for the purposes of such section and to encourage and facilitate the accumulation of funds for the purchase of savings bonds and savings certificates, to prepare and issue postal-savings stamps in such denominations as he may prescribe."

This amendment, which would authorize the Postmaster General to issue postal-savings stamps in any denominations prescribed by him (at present he can not issue such stamps in denominations of more than $1), is necessary in order that full utilization may be made of postal-savings stamps as a device to facilitate and encourage the accumulation by small investors of the minimum amount necessary to buy savings bonds or certificates. This amendment was recommended by the Treasury and Post Office Departments.

On page 5, in subsection (e), strike out all after "Department" in line 14 through the word "therefor" in line 16, and insert in lieu thereof the following: "and of the Postal Service, in connection with the handling of savings bonds, savings certificates, and stamps or other means provided to evidence payment therefor, which sums may be used for additional employees or any other expenditure, wherever or in whatever class of post office incurred, in connection with such handling."

This amendment will merely give the Post Office Department authority to expend funds which the bill already authorizes the Treasury Department to advance to the Post Office Department in order that it may be in a position to perform the work which the bill imposes upon it in connection with the sale and other handling of savings bonds and savings certificates.

NEED FOR THE LEGISLATION.

The 1942 Budget submitted to the Congress last month indicates that our contemplated national-defense program has now been increased to approximately $28,500,000,000 in appropriations, contract authorizations, and recommendations. It also indicates that the estimated expenditure programs will result in combined deficits for the fiscal years 1941 and 1942 of $15,400,000,000. The balance of the borrowing authority on January 31, 1941, was $1,123,000,000 under the general limitation, and $1,628,000,000 under the national-defense limitation. This combined total of $2,751,000,000 provides the Treasury with borrowing authority sufficient only for the next four months, and even in that period it would be restricted to short-term obligations for a larger part of its financing operations than seems advisable at this time.

The Secretary of the Treasury appeared before a subcommittee of your committee and testified that it would not be advisable to undertake the financing of the enlarged national-defense program through the issuance of short-term securities. Mr. Morgenthau pointed out that short-term securities are for the most part purchased by commercial banks, thereby causing a further increase in deposits. In order to avoid, as far as possible, encouraging such a result, he recommended that the Treasury be permitted to issue obligations more attractive to permanent investors outside of the banking system.

GENERAL EXPLANATION OF THE BILL.

The bill amends the Second Liberty Bond Act, as amended, so as to limit the face amount of public-debt obligations issued under the authority of that Act to an amount not to exceed in the aggregate $65,000,000,000 outstanding at any one time. It is believed that this increased limitation will amply cover the Treasury's present anticipated financing requirements for the current and ensuing fiscal year. The bill terminates the authority to issue $4,000,000,000 of short-term defense obligations provided in the First Revenue Act of 1940 and certain obsolete authority to issue debt obligations of a character which the Treasury does not need and which, therefore, should be eliminated from the statute books. The future borrowing authority fixed by this bill will be all-inclusive.

In view of the enlarged financing program facing the Treasury Department, it is desirable that it have greater flexibility in the types of securities which may be offered to meet the requirements of various classes of investors. Therefore, this bill further amends the Second Liberty Bond Act so as to broaden the authority under which United States savings bonds are issued and to provide for a new class of security to be called Treasury savings certificates. The statutory limit on the term for which savings bonds may be issued would continue to be 20 years, as at the present, while a limitation of 10 years would be placed on the Treasury savings certificates. It would also provide that both classes of securities may be issued on an interest-bearing basis, on a discount basis, or on a combination interest-bearing and discount basis, and that the Secretary of the Treasury may fix by regulation the amount of savings bonds and savings certificates which may be held by any one person at any one time.

In addition, the Treasury would be authorized to issue stamps or provide other means to evidence payments for savings bonds and savings certificates, and to provide for the exchange of savings certificates for savings bonds. This would permit the Treasury to carry on a program encouraging more popular participation in defense financing and to offer securities of a character which should facilitate and promote thrift and savings.

In so far as Federal taxation of Federal securities is concerned, the bill removes the tax-exemption privilege by providing that all obligations issued in the future by the United States and its agencies and instrumentalities (except Territories, possessions, and the District of Columbia) shall be subject to Federal taxes to the same extent as private obligations.

The bill makes no change in existing law with respect to the taxation of Federal securities by the States and their political subdivisions nor does it affect in any way the taxable status of obligations of States, municipalities, and other local governmental agencies.

It will remove, however, all privileges of exemption from Federal taxation not only from direct obligations of the United States but also from all obligations issued by the various Federal corporations, instrumentalities, and agencies. While the elimination of the Federal tax-exemption privilege will apply to all future issues of Federal obligations, securities issued solely to replace those issued prior to the effective date of the Act which have been lost or destroyed, or securities issued in different denominations in exchange for securities issued prior to such effective date and bearing the same maturity and interest rate, will have the same tax-exemption status as the securities replaced or exchanged. On the other hand, any refunding obligations issued subsequent to the effective date of the Act would be fully subjected to Federal taxes under the provisions of the bill.

Your committee feel that it is particularly appropriate that this step should be taken in connection with the financing of the national-defense program. All should be called upon to share in the enormous task of supplying the revenue necessary to finance this program. It becomes urgent therefore, from an equitable point of view, that no subscribers to any given class of securities should receive preferential treatment. This result is impossible if some securities are issued with tax-exemption privileges which are worth little or nothing to the poorer classes of subscribers, but which are worth a great deal to those in the higher income brackets. Preferential treatment to this latter class is incompatible with democratic methods of financing the defense program and should be removed.

Your committee strongly recommend prompt consideration and action on this important legislation. Two factors particularly support this recommendation: (1) As the Treasury is rapidly approaching the limit of its borrowing authority, it is becoming daily more restricted in the flexibility of its financing operations, and flexibility is essential to the successful operation of the vast financial program necessary to arm and defend the United States and guarantee its national security in the world to-day; (2) as large amounts of long-term Federal obligations mature on March 15, 1941, it is important that the present legislation be enacted before that date.

DETAILED ANALYSIS OF THE BILL.

[The Senate report uses as its own the language of the House report (No. 20) on the detailed analysis of the bill, which analysis is printed on pages 569 to 573 of this Bulletin.]

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